

FUAD AL-OMAR &
MOHAMMED ABDEL-HAQ

Islamic Banking

THEORY, PRACTICE
& CHALLENGES

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Dedications

To My Parents, My Wife and Children,
Fuad

To My Parents and My Wife Lynn,
Mohammed

FUAD AL-OMAR &
MOHAMMED ABDEL-HAQ

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Preface

This book will tell a story which is designed to investigate the practice of Islamic banks within different economic, financial, social, legal and religious environments. It covers Islamic banks working in different environments, the future and challenges faced by Islamic banks and sets out the authors' conclusions.

A story does not tell everything, it tells only those things that are necessary to inform the plot and develop the characters.

The illustrative materials used in this study are of mixed status: some are taken from respectable researches where qualified generalizations are given concerning reliably recorded regularities, some are taken from informal interviews and sources given by colourful people involved in the industry of Islamic banking; many fall in between. The justification for this approach is that the illustrations together fit into a coherent framework that ties together bits of experience the reader might find interesting and provides the reader with a guide worth testing in case studies of her or his work. The framework is presented in logical steps.

To the researchers and academics who do find faults and errors in the book, we hope that these findings will motivate them to produce better publications in the future.

The authors believe that the Qur'ān is the word of Allah and is beyond question. It is therefore going to be treated as fact, without question. It is not our intention to get involved in the debate between the four Islamic schools of *fiqh*, for two obvious reasons: we do not think that bankers and other professionals would be interested in engaging in this sort of discussion, but that if any of them is interested, the libraries have plenty of relevant books in both Arabic and English. It is important to stress that the problems of Islamic banks are not readily apparent though they can generally be classified into two categories: first, problems faced by any financial institution in a developing country (exchange rates, weakening currency, country risks) and, as a consequence, a lack of profitable investment opportunities; second, problems specific to Islamic banks. This book tackles the second problem.

Chapter 1 looks at the framework of Islamic finance. Chapter 2 gives an overview of Islamic banking. Chapters 3, 4, 5 study Al-Barakah Bank, London, the Jordan Islamic Bank and Al-Baraka Turkish Finance House.

Chapter 6 looks at Islamic banking in Malaysia and Chapter 7 at derivatives and the challenges facing the development of Islamic secondary-market instruments in the Islamic Development Bank. Chapter 8 examines the Islamic banking experience in Pakistan, while Chapter 9 gives a comparative analysis of the financial statements of Islamic and non-Islamic banks. Chapter 10 discusses the challenges faced by Islamic banks. Chapter 11 outlines the important considerations to be addressed before engaging in Islamic transactions. The book ends with the conclusions drawn by its authors. While the findings cannot always be generalized, for everyone they raise profound questions concerning the role of belief.

The book is based partly on the Ph.D. thesis of M.K. Abdel-Haq, which was submitted to the School of Business, Oxford Brookes University, Oxford in collaboration with the Oxford Centre for Islamic Studies under the supervision of a team directed by Dr Brian Shaw and Dr David Browning. It gives the views and opinions of the authors and does not necessarily give those of the institutions where they are working.

Glossary

Amana

Current accounts, regarded as *amana* (trust). An important value of an Islamic society in mutual dealings. It also refers to deposits in trust. A person can hold a property in trust for another, sometimes by express contract and sometimes by implication of a contract.

Adalah

Justice.

Akl amwal al-nas bai'-al-bātil

Acquiring someone else's property unjustifiably. It is the Qur'ānic expression for unlawful acquisition of wealth such as *ribā*, bribery, and usurpation of orphan's wealth.

Bai' Mu'ajjal

Literally meaning a credit sale. Technically a financing technique adopted by Islamic banks. It is a contract in which the seller allows the buyer to pay the price of a commodity at a future date in a lump sum or in instalments. The price fixed for the commodity in such a transaction can be the same as the spot price or higher or lower than the spot price.

Bai' Salam

It is defined as advance payment for goods. According to normal rules and regulations no sale can be effected unless the goods are in existence at the time of the bargain, but this sort of sale forms an exception to the general rule provided the goods are defined and the date of delivery is fixed. The objects of this sale are mostly tangible things and cannot be gold or silver because these are regarded as monetary values. Barring this, *bai' salam* covers almost everything which is capable of being definitely described as to quantity, quality and workmanship.

Falāḥ

To thrive, to become happy, to have luck or success. Technically it implies success in the *Akhira* (Hereafter). The *falāḥ* presumes belief in one God, the apostlehood of Prophet Muḥammad, *Akhira* and conformity to the *Sharī'ah* in behaviour.

Fiqh

Islamic jurisprudence. The science of the *Sharī'ah*. It is an important source of Islamic economics.

Fuqahaā'

Jurisprudence.

Gharar

The *Sharī'ah* determined that in the interests of fair, ethical dealing in commutative contracts, unjustified enrichment should be prohibited. This policy precludes any element of uncertainty or mere speculative risk.

Al-Ghunm bi-l-ghurm

The rationale of the principle of no profit-sharing without risk-sharing is that earning profit is legitimized by engaging in an economic venture and thereby contributing to the economy.

Ḥadīth

The sayings of the Prophet Muhammad (PBUH).

Ḥalāl

Anything permitted by the *Sharī'ah*.

Ḥarām

Anything prohibited by the *Sharī'ah*.

Ijārah

Letting on lease. Sale of a definite usufruct in exchange for definite reward. It is commonly used for wages. It also refers to a contract of land leased at

a fixed rent payable in cash and to a mode of financing adopted by Islamic banks. It is an arrangement under which the Islamic bank leases equipment, a building or other facility to a client, against an agreed rental. The rent is so fixed that the bank gets back its original investment plus a profit on it.

Ijārah wal-'Iqtinā

A mode of financing adopted by Islamic banks. It is a contract under which the Islamic bank finances equipment, building or other facilities for the client against an agreed rental together with an undertaking from the client to make additional payments in an account which will eventually permit the client to purchase the equipment or the facility. The rental as well as the purchase price is fixed in such a manner that the bank gets back its principal sum along with some profit which is usually determined in advance.

Ijtihād

Effort, exertion, diligence. Technically, endeavour of a jurist to derive or formulate a rule of law on the basis of evidence found in the sources.

Ijmā'

Consensus of the jurists (*mujtahidin*) on a certain question in a certain age.

Isrāf

Immoderateness, exaggeration, waste. Covers spending on lawful objects but exceeding moderation in quantity or quality; spending on superfluous objects while necessities are unmet; spending on objects which are incompatible with the economic standard of the majority of the population.

Istiṣnā

Basically a contractual agreement for processed goods and commodities, allowing cash payment in advance and future delivery or a future payment and future delivery. This flexibility allows the bank to pre-sell to its clients for future delivery on a cash-on-delivery basis and then negotiate the purchase.

Jahili contracts (forbidden):

Muzābana the exchange of fresh fruits for dry ones in a way that the quantity of the dry fruit is actually measured and fixed but the quantity of the fresh fruit to be given in exchange is guessed at while still on the trees.

Muḥaqalah the sale of grains still growing (i.e. unharvested) in exchange for an equal quantity of harvested grains.

Mulāmasah the sale of goods which the purchaser has touched but not examined or inspected properly.

Munābadhah a contract confirming the sale of goods by throwing them to the purchaser without prior inspection by him of the goods.

Maḥall

Subject matter.

Māl

The concept of property, wealth or income. Something which can be hoarded or secured for use at the time of need.

Māl Mutaqawwam

Wealth that has a commercial value. It is possible that certain wealth has no commercial value for Muslims (*ghair mutaqawwam*) but is valuable for non-Muslims. Examples are wine and pork.

Maisir

An ancient Arabian game of chance played with arrows without heads and feathering, for stakes of slaughtered and quartered camels. It came to be identified with all types of gambling.

Maqāsid Al-Sharī'ah

Objectives of the *Sharī'ah*. Technically it refers to the protection of life, religion, reason, progeny and property. These objectives also define basic needs of an Islamic economy.

Al-Ma'qud'alayh

Object of contract.

Mithlī

Goods returned in kind, i.e. gold for gold, silver for silver, wheat for wheat.

Mubah

Object must be lawful (i.e. something which it is permissible to trade in).

Mudārabah

A form of partnership where one party provides the funds while the other provides the expertise and management. The latter is referred to as the *muārib*. Any profits accrued are shared between the two parties on a pre-agreed basis, while capital loss is borne by the partner providing the capital.

Mudārib

In a *mudārabah* contract, the person who acts an entrepreneur.

Muqāradah

An agreement in which a person leaves his commodities (stock-in-trade) with another person so that the latter may sell them. The profit is for the owner of the commodities. Also used as an alternative for *mudarabah*.

Murābahah

Literally means a sale on profit. It is technically a contract of sale in which the seller declares his cost and profit. This has been adopted (with certain modifications) as a mode of financing by a number of Islamic banks. As a financing technique, it involves a request by the client to the bank to purchase a certain item for him. The bank does that for a definite profit over the cost which is settled in advance. Many people have questioned the legality of this financing technique because of its similarity with *ribā*.

Mushārahah

A financing technique adopted by Islamic banks. It is an agreement under which the Islamic bank provides funds which are mixed with the funds of the business enterprise and others. All providers of capital are entitled to participate in management, but not necessarily required to do so. The profit is distributed among the partners in pre-agreed ratios, while the loss is borne by each partner strictly in proportion to respective capital contributions.

Najis

Something that is impure/unclean (i.e. pigs or a person that has been touched by something impure).

Qard Hasan

A pure loan transaction in which the client obtains cash from the bank to be returned at a stipulated future date, free of interest.

Qimār

Gambling. Technically an agreement in which possession of a property is contingent upon the happening of an uncertain event. By implication it applies to agreements in which there is a definite loss for one party and a definite gain for the other without specifying which party will lose and which will gain.

Qiyās

Measure, example, comparison, analogy. Technically meaning a derivation of the law on the analogy of another law if the basis (*'illah*) of the two is the same. It is a primary source of Islamic economics.

Qur'ān

The book of Allah revealed to the Prophet Muhammad (PBUH).

Ribā

An excess or increase. Technically meaning an increase which is a loan transaction or in exchange for a commodity accrued to the owner (lender) without giving an equivalent counter-value or recompense (*'iwad*) in return to the other party; every increase which is without an *'iwad* or equal counter-value.

Ribā al-faḍl

A sale transaction of the *amwal al-ribawiyyah* (those commodities in which the injunction of *ribā* is applicable) in which a commodity is exchanged for the same commodity but unequal in amount and the delivery of at least one commodity is postponed. To avoid *ribā al-faḍl*, the exchange of commodities from both sides should be equal and instant. *Ribā al-faḍl* has been prohibited by the Prophet Muhammad (PBUH) as a measure to forestall the *ribā* from creeping into the economy through the back door.

Ribā al-nasī'ah

Increment on the principal of a loan payable by the borrower. It refers to the practice of lending money for any length of time on the understanding that the borrower would return to the lender at the end of this period the amount originally lent together with an increment in consideration of the lender having granted him time to pay.

Sabab

Underlying cause.

Ṣadaqah

Charity. In its widest sense it means an attitude of mutual appreciation, mutual assistance, an act of loyalty to God and to one's fellow beings, a sense of shared humanity. At a material level it consists of two kinds: *ṣadaqah al-tatawwu*, given at the free will of the donor; and *zakāh*, the obligatory tax imposed by the Qur'ān on the wealth of every Muslim having financial means beyond a certain limit.

Ṣalla-llāhu 'alaihi wa Sallam

Refers to the Prophet Muhammed. Whenever his name is mentioned a Muslim must repeat this saying, which means may the peace and blessings of Allah be upon him.

Ṣarf

Sale of monetary value for monetary value.

Sharī'ah

Refers to divine guidance as given by the Qur'ān and the *Sunnah* of the Prophet Muhammed (PBUH) and embodies all aspects of the Islamic faith, including beliefs and practice.

Shirkah

A contract between two or more persons who launch a business or financial enterprise to make profits.

Sunnah

Custom, habit, way of life. Technically the utterances of the Prophet Muhammad (PBUH) other than the Qur'ān, known as *aḥadīth*, or his personal acts or sayings of others tacitly approved by him.

Tabdhīr

Spending wastefully on objects which have been explicitly prohibited by the *Sharī'ah* irrespective of the quantum of expenditure.

Tawhīd

Oneness of God. God is one and does not share anything with anybody, neither in personality nor qualities. Belief in *tawhīd* is fundamental to Islam, and the value system of Islam is based on this belief. It affects the economic behaviour of Muslims in a number of ways.

Ummah

Muslim nation.

'Ushr

The meaning of *'ushr* (pl. *'ushūr*) is a tenth. As a technical term, *'ushr* refers to the *zakāh* levied on agricultural produce of lands owned by Muslims at the rate of ten per cent if the land is irrigated by rainfall and at the rate of five per cent on artificially irrigated lands. *'Ushr* is not levied if there is no produce.

'Ushūr

Means one-tenth, plural of *'Ushr*. *'Ushūr* were imposed on the merchants who came to Muslim lands from non-Muslim countries which had no treaty with Muslims. Eventually *ushūr* were extended to all the caravans, whether for internal or external trade, and to Muslim and non-Muslim merchants. For a Muslim merchant, *ushūr* were the same as 2.5 per cent annual *zakāh* on merchandise. A *dhimmi* (people of the book, for example, Christians and Jews) had to pay double what a Muslim paid, whereas a merchant from a foreign country which had no relations with Muslims had to pay double what a *dhimmi* paid. It used to be an important source of revenue for the Muslim state.

Al-Wadīyah

Deposit, trust. Technically a contract whereby a person leaves valuables as a trust for safe-keeping.

Zakāh

An obligatory periodic levy on all Muslims who have wealth or income above a certain minimum. *Zakah* is earmarked by the Holy Qur'ān to specific categories of people. The object is to take away a part of the wealth of the well-

to-do and distribute it to the poor and the needy. It is levied on such things as cash, cattle, agricultural produce, minerals, capital invested in industry and business. The distribution of *zakāh* funds has been laid down in the Qur'ān (9: 60) and is for the poor and the needy.

Abbreviations

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
ABT	Al-Baraka Turkish Finance House (Al-Baraka Turk)
AIBL	Al-Baraka Bank, London
ATM	Automated teller machine
BBMB	Bank Bumiputra Malaysia Berhad
BCCI	Bank of Credit and Commerce International, London
BIMB	Bank Islam Malaysia, Berhad
BOE	Bank of England
BOT	Build, operate and transfer
CII	Council of Islamic Ideology
FIBB	Faisal Islamic Bank of Bahrain
FSC	Federal <i>Shari'ah</i> Court
GDP	Gross Domestic Products
GOP	Government of Pakistan
HBFC	House Building Finance Corporation
IAIB	International Association of Islamic Banks
IBI	Faisal Islamic Bank International, based in Copenhagen
IBJ	Industrial Bank of Japan
IBP	Islamic Banks Portfolio
ICP	Investment Corporation of Pakistan
IDB	Islamic Development Bank, Jeddah, Saudi Arabia
IFBS	Interest-free banking scheme
IIMM	Islamic Inter-bank Money Market
IRTI	Islamic Research and Training Institute
ITC	Islamic Trading Company
ITFO	Import Trade Financing Operations
JIB	Jordan Islamic Bank for Finance and Investment
KFH	Kuwait Finance House
LTTFS	Long Term Trade Financing Scheme
OIC	Organization of the Islamic Conference (It is an inter-governmental organization comprising 51 Islamic States. It was established in pursuance of a decision taken during the first Summit Conference of Muslim Heads of State, held in

Rabat (Morocco) in 1389H (1969), following the burning of the Al-Aqsa Mosque in Al-Quds (Jerusalem). Its objective is to promote Islamic solidarity and cooperation).

PNIT	Pakistan National Investment Trust
PPP	Pakistan People's Party
SBP	State Bank of Pakistan
SFH	Special Finance House
SPTF	Skim Perbankeru Tanpa Faedah (Interest-free Banking Scheme)
UIF	Unit Investment Fund
UMBC	United Malayan Banking Corporation (UMBC)
UV	Unit value
WAPDA	Water and Power Development Authority

CHAPTER 1

Framework of Islamic Finance

Background

The rules and norms of Islam derive from the Qur'ān and the *Sunnah* (the living tradition of the Prophet Muhammad, *ṣalla-llāhu 'alaihi wa sallam*).¹

The word *Sunnah* means a manner of acting, an established rule of conduct or practice. Applied to the life of the Prophet Muhammad, *ṣalla-llāhu 'alaihi wa sallam*, this meant, therefore, a rule deduced from the sayings or actions of the Prophet either in a specific pronouncement or action or in his approval of an action or practice of someone else, as recorded in a *ḥadīth* or tradition. The term *ḥadīth* thus refers to the report of a particular occurrence. Although one often comes across the words *Sunnah* and *ḥadīth* used almost interchangeably, the latter refers to a tradition or story of the Prophet while the former relates to the practice or ruling deduced from it.

There are in addition to these two primary sources of law two dependent sources, namely *ijmā'* (consensus) and *qiyās* (reasoning by analogy). If one cannot find either a relevant text from the Qur'ān or a relevant *ḥadīth* then one turns to a third source, namely the general consensus among Islamic scholars of a particular age regarding a ruling appropriate and applicable to the situation in hand. The ruling thus unanimously decided upon became fixed and definite and part of the permanent body of Islamic jurisprudence.

The authority of *ijmā'* is based upon distrust of individual opinion. There is assurance of freedom from error in the communal mind. The Prophet had observed: 'My nation will not agree unanimously in error'. If the community were of one mind on a particular matter in an area on which their unanimous view was not inconsistent with that of the Qur'ān or *Sunnah*, it was accepted as valid. The limitation upon the authority of *ijmā'*, that it must not be in conflict with the Qur'ān or the *Sunnah*, is obviously a significant one.

If neither the Qur'ān nor *Sunnah* nor *ijmā'* could provide a ruling to solve the problem in hand, jurists had, through devout and careful reflection, to derive an appropriate ruling by logical inference from the particular to the general or vice versa, and/or by analogy. The authority for such a resort to individual reasoning (*ijtihād*) is usually attributed to a *ḥadīth* which records the conversation between the Prophet and Mu'ādh Ibn Jabal, whom he appointed as Governor in the Yemen.²

Logical reasoning by analogy, known as *qiyās*, was the subject of much philosophical inquiry in order to extract the underlying principle from the particular circumstances of a particular case. It is important to remind ourselves of an important principle of Islamic law explained by one of the well-known Muslim scholars, Tafseer Al-Razi: law in Islam is determined by what Allah and His Messenger said, not by analogy and reasoning. Some of the most important of the directives and rules, axiomatic for Muslims and relevant to our subject, are that:

- The Qur'ān is the revealed word of Allah, transmitted *verbatim*, and explained most authoritatively through the *Sunnah*.
- The *Shari'ah* is the Divine Law, derived directly from the words of the Qur'ān or from the *Sunnah*, or indirectly from the same sources through reasoned deduction or analogy.
- Human reason has considerable sovereignty within the law; it has no sovereignty over the law. In other words, what Allah has permitted cannot be unconditionally prohibited, nor can what He has prohibited be made unconditionally permissible (Qaradawi, nd). Ibn Khaldūn, in his discussion of the proper relation of philosophy to society and thereby to the law states that, unlike the human philosopher, the Divine Legislator is not bound by the limits of theoretical reason. What the law declares must be accepted and never doubted, even when it passes or appears to contradict human reasoning (Mahdi, 1964).
- The law includes the general principle that if nothing is specifically prohibited, it may be considered, in principle, to be permitted.
- The concept of prosperity (Kahf, 1981) is defined in the *Shari'ah* in terms of the pleasure of Allah, not in terms of accumulation of surplus wealth. Virtue, righteousness and fulfilment of servanthood to Allah are the keys to His pleasure. Virtue and righteousness can be achieved through good actions and purification of human behaviour from evil and vice.
- The concept of property (*māl*) is special and unique in Islam (Kahf, 1981). *Māl*, whether as wealth or income, is considered as a good, a favour, from Allah; it is not an evil. Heaven is open equally to the rich and the poor. *Māl* is a means that may be used for good or for evil; poverty is not necessarily associated with virtue; indeed, in some instances, it may be linked to disbelief or the weakening of belief (Ahmad, 1991). What matters is not whether one has wealth but how it is obtained and how expended.

Goals of Islam (*Maqāsid al-shari'ah*)³

These are based on *tawhīd* (the oneness of God). *Tawhīd* implies that the universe has been consciously designed and created by the supreme being, who is one and unique, and that it did not come into existence by chance or accident (Qur'ān 3: 191; 38: 27; 23: 15).

The human being is the supreme being's Khalifah or vicegerent on earth (Qur'an 2: 30; 6: 165) and the resources at his disposal are a trust (Qur'an, 57: 7).

Since everyone, rather than any single privileged person or members of a particular race or group or country, is a Khalifah, Khalifah stands essentially for the fundamental unity and brotherhood of mankind. This needs a concept to ensure implementation, so it must be accompanied by *adalah* (justice). Establishment of justice had, therefore, been declared by the Qur'an to be one of the primary objectives. In fact, the Qur'an places justice 'nearest to piety' (Qur'an, 5: 80) in terms of its importance in the Islamic faith.

The intense commitment of Islam to brotherhood and justice makes the well-being (*falāh*) of all human beings the principal goal of Islam. This well-being includes physical satisfaction, because mental peace and happiness can be achieved only by means of a balanced realization of both the material and spiritual needs of the human personality. Mere maximization of total output cannot, therefore, be a sufficient goal of a Muslim society. Maximization of output must be accompanied by efforts directed to ensure spiritual health at the inner core of human consciousness, and justice and fair play at all levels of human interaction. Only development of this kind would be in conformity with the *Maqāṣid al-Sharī'ah* or goals of the *Sharī'ah* (Chapra, 1993).

Object of contracts (*Al-Ma'qud'alayh*)

In his book *The Theory of Contracts in Islamic Law* Rayner (1991) gave a detailed analysis about the object of contracts. A brief summary is as follows. The importance attached by the *fuqahā'* (jurisprudence) to a clear, precise definition of the object of a contract is indicated by the many detailed regulations worked out about it. Its importance rests in part on moral and religious considerations, in part on the need to maintain balance between the diverse effects resulting from legal acts, and in part on the need to prevent all aleatory or usurious transactions.

The law of contract is based around the concept of property (*māl*). Most schools require four conditions concerning the object which must be satisfied to effect a valid contract: lawfulness, existence, deliverability, and precise determination (Rayner, 1991).

Lawfulness

The object must be lawful (*mubāḥ*), that is, something in which it is permissible to trade. It must be *māl mutaqaawwim*, that is its subject matter (*maḥall*) and underlying cause (*sabab*) must be lawful; and it must not be proscribed by Islamic law, nor a nuisance to public order or morality.

Inherent in the lawfulness of the object is the condition that a person may not deliver into another's possession or transfer to a third party the right of

ownership of an object of which he is not himself the owner, without the authorization of its legal owner or by virtue of delegated authority conferred upon him by that owner.

Existence

The object of a contract must be in existence at the time of the contract. Thus it is illegal, for example, to sell a foetus.

This condition is mitigated somewhat by the authorization of *bai' salam* and *istiṣnā* contracts (see pp. 23-4) which respectively cover future provision and future manufacture of goods. It follows that when the object of a contract is an actual thing it must be in existence at the time of the contract, but where the object is a promise to deliver or to manufacture, then the object of that promise need not be in existence at the time of the contract, but must be possible and definite; that is, it must be capable of being defined and delivered.

Delivery

The object of a contract must be capable of certain delivery. Where a contract consists of an obligation to be performed, the obligation must be one capable of being executed with certainty. The classical jurists, therefore, prohibit the sale of a camel which has fled, a bird in the air, or a fish in water.

The object of a contract must be clear and definite. The overriding concern of the *fuqahā'* is to prevent conflicts and unjustified profits arising out of uncertain or aleatory contracts. The condition that the object must be capable of delivery or execution can be understood as an aspect of the right to title condition, namely, that the object must be in the ownership of the person intending to transfer ownership.

If the object of a contract is a real good, an item, then its ownership must be known, and right to transfer must be legal; and its quantity and value must be known (no transaction is valid if the object is proscribed in Islamic law).

If the object of a contract is a promise to manufacture or deliver a good, an item, in the future the promise must be feasible and the goods to be delivered must be known (defined).

Precise determination

Finally, the object of a contract must be determined precisely as to its essence, its quantity and its value. Similarly, where an object is an obligation of performance, the nature and value of the obligation must also be determined precisely. In the case of benefits derived from property, acts or services not present at the time of contracting, the object of the proposed

contract must be both feasible and capable of precise definition, as well as lawful.

This is a principle which the *fuqahaā'* formulated in order to prevent uncertainty and conflict between contracting parties in situations where a contract is rescinded or terminated for some cause and either party is seeking a remedy.

Key issues

Ownership

An understanding of the concept of property in Islam is essential to understanding the behaviour of consumer and producer. Absolute or pure concepts of property are important in shaping the psychological environment within which economic activity is motivated and preferences between kinds of relationship and transaction made. The following points are particularly relevant (Abadi, 1977):

1. property is unconditionally owned only by Allah (Qur'ān, 24:33 and 57:7);
2. property among human beings is a form of stewardship or caretaking, that is, it is conditional, and for the use of every property the person is answerable to Allah;
3. conditional ownership is either collective or individual:
 - (a) collective ownership extends to such fundamental natural resources as water, air and fire; ownership of such resources cannot be held by an individual; the actual use of such resources by individuals may be recognized provided such use does not adversely affect rights of use, for example access, by other individuals.
 - (b) individual ownership extends to such things as goods, buildings, livestock, and includes rights to lease, rent or re-sale.

Three basic principles are accepted in the *Shari'ah* as to the way this should be done. Ownership of resources by man is not absolute. It is a social obligation to be undertaken within the limits set for it. Allah owns the resources and man is only a trustee in their use. The way to pursue the acquisition and development of resources, that is, the economic aspect of man's life, is likewise not completely free. There are moral and legal constraints. Although individuals are allowed to own wealth in the normal way, the final aim is that this wealth should be of use to the community as a whole: social solidarity is the well-being of individuals and societies. Wealth can come into the possession of any individual through her or his work, or through inheritance and grants which are also conceived of originally as the results of work.

All forms of activities that allow an individual to acquire wealth in a *haram* way are strictly prohibited. These include (Hamidi, 1986): hoarding,⁴ gambling and betting in all forms; cheating in quality, quantity, weight or any

specifications of the goods and services traded or acquired or disposed of; all types of fraudulent sale or sales used as an excuse to charge interest, trade malpractices (for example, creating artificial scarcities); and interest in any form and at any rate.

Zakāh

Islam requires every Muslim, having resources in excess of a certain basic amount, to pay *zakāh* as a given proportion of her or his net worth or agricultural output. *Zakāh* is an amount levied on all persons having wealth above an exemption limit, in order to purify their wealth and their souls. The rate of tax and the exemption limit are set by the *Shari'ah* (Khan, 1990). The main purpose of the tax is redistribution of wealth and income. However, the transfer of income generates changes in the composition of demand for commodities that satisfy basic needs. Consequently, the composition of aggregate supply should change in the direction of more food, clothing and shelter, and fewer luxuries (Kahf, 1982). The proper recipients of expenditure of *zakāh* funds are specified in the Qur'ān (9: 60): the poor and the needy, *zakāh* collectors, new converts to Islam, travellers (when in difficulty), for the sake of Allah, the relief of captives and debtors, and otherwise as interpreted by Muslim scholars.

Most Muslim scholars believe that a major objective of *zakāh* is to alleviate poverty. That objective is not left to private individuals, although charity (*ṣadaqah*) is also strongly encouraged. Without doubt *zakāh* is meant to be collected and distributed in an organized collective way (Salama, 1982).

The basic instrument for circulation of wealth in an Islamic society is, thus, a mandatory, fixed and stable amount, collection and payment of which is a religious duty. It is not a fiscal measure subject to the vagaries of government policies (Uzair, 1981).

Zakāh is calculated at 2.5 per cent of the total value of capital and profits minus unrecovered debts and depreciation. In agriculture it varies from 5 per cent to 10 per cent, according to the type of irrigation. There is a different way for calculating the tax on livestock; it varies, however, from 1.84 per cent to 2.53 per cent according to the number, age and kind of livestock as mentioned in the *Sunnah*. *Zakāh* should be collected and distributed locally. Only the surplus may be utilized elsewhere and must be expended according to the eight heads of expenditure indicated in the Qur'ān.

The levy of *zakāh* on all wealth, including gold and silver and idle balances held in safes, should help induce the *zakāh* payers to seek income on their wealth to enable them to pay the *zakāh* without reducing their wealth. This should help to increase the availability of funds for investment. Thus, in a society where the Islamic values have been internalized, gold and silver holdings and idle balances would tend to go down, leading to a rise in investment and employment (Chapra, 1993).

Forbidden contracts/elements

The usufruct, sale and trading of certain commodities, such as wine or alcohol products, and pork and pork products, are prohibited (*ḥarām*) to Muslims. Any prospective Muslim buyer who would like to conduct his life according to Islamic law is therefore precluded from use or enjoyment of these commodities, and any contract involving such commodities would be void on the grounds of their illegality. The flesh and bones of animals that have died by other means than ritual slaughter (*ḥalāl*) cannot be sold. Idols are also forbidden commodities.

Ribā

Among the most important teachings of Islam for establishing justice and eliminating exploitation in business transactions is the prohibition of all sources of unjustified enrichment (*akl amwal al-nas bai'-al-bātil*). The Qur'ān instructs Muslims emphatically not to acquire each other's property *bi-al batil* (wrongfully) (2: 188 and 4: 29, 4: 161 and 9: 34).

The Qur'ān and *Sunnah* teach principles whereby a Muslim society can know or can deduce what is wrongful as a source or means of acquiring property. One of the important sources of wrongful or unjustified earning is receiving any monetary advantage in a business transaction without giving a just counter value. *Ribā* represents, in the Islamic value system, a prominent source of unjustified advantage.

Ribā is a sin under Islamic law, and even those hired to write the contract or who witness (and thus confirm) the contract are a party to the sin.⁵ There is a consensus among Muslim scholars that this prohibition extends to any and all forms of interest and there is no difference between interest-bearing funds for purposes of consumption or investment (Islamic Fiqh Academy, 1986).

Prohibition of *ribā* means that money can be lent lawfully only for either charitable purposes (without any expectation of return above the amount of the principal), or for purposes of doing lawful business – that is, investment on the basis of profit and risk-sharing – an investment of the kind that seeks profit while sharing the risk is encouraged in Islam, indeed it is commended.

The clear distinction between trading and *ribā* in Islam needs emphasis, the former being not merely permitted but strongly encouraged. Economic activity and prosperity are not tolerated reluctantly as a worldly necessity, but viewed as a religious virtue or even as an obligation, provided the activity conforms to *Sharī'ah*. Thus, while both trading and *ribā* generate an increase in capital, the increase generated by trading is welcome, and only that generated by *ribā* is forbidden. *Sharī'ah* does not consider money as a commodity such that there should be a price for its use. Money is a medium of exchange in an asset-oriented economy, and a store of value.

The prohibition can be expressed in more technical terms by saying that while money is recognized in Islam as a means of exchange it may not lawfully be regarded as a commodity for exchange (Wohlers-Scharf, 1983).

The important difference (among others) between trade and *ribā* is that the business risk in trading is allocated more evenly among all the parties involved, whereas in *ribā* operations the business risk lies heavily, if not solely, with the borrower (Ashker, 1987). In its widest general implication *ribā* signifies any increase of capital not justified by a risk taken.

While we have yet to discuss its precise meaning, we can be quite certain of the unequivocal condemnation of *ribā* in the Qur'ān. The Qur'ānic prohibition appears in four places – 30: 39; 4: 161; 3: 130-2; and 2: 275-81. The clearest verses are these:

Those who devour *ribā* will not stand except as he stands who has been driven to madness by the touch of Satan. That is because they say: trade is only like *ribā*, but God has permitted trade and forbidden *ribā* . . . God will deprive *ribā* of all blessing. (2: 275-6)

O ye who believe! Fear God, and give up what remains of your demand for *ribā*, if you are indeed believers. If you do not, take notice of war from God and its Apostle: but if you turn back, you shall have your capital sums: deal not unjustly, and you shall not be dealt with unjustly. If the debtor is in difficulty, grant him time till it is easy for him to repay. But if you remit it by way of charity, that is best for you if only you knew. (2: 278-80)

O you who believe! Devour not *ribā*, doubled and multiplied, but fear God, that you may prosper. (3: 130)

In recent times, the *fiqh* (Islamic jurisprudence) Academy of the Islamic Conference, held in 1986, supported the restrictive interpretation of *ribā* which had been adopted by the early jurists, condemning all interest-bearing transactions as void. Many discussions have taken place about Islamic alternatives to Western banking practices, alternatives which avoid *ribā* and thereby violation of the *Shari'ah*. Several mechanisms, such as *mudārabah* (see p. 12) between client and bank, partnership, *muqāradah* (Islamic bonds on which no interest is earned, but whose market value varies with the anticipated but variable profit share) and forms of lease financing have been put forward and discussed by Islamic economists with increasing optimism as to their financial efficacy.

Ribā is an Arabic word meaning, literally, increase, addition, expansion or growth, but it is not increase or growth as such which Islam has prohibited. As a *Shari'ah* term, *ribā* refers to the premium that must be paid by the borrower to the lender along with the principal amount as a condition for the loan or for an extension in its maturity.

The term is used in the *Shari'ah* in two senses, *ribā al-nasi'ah* and *ribā al-fadl*. *Ribā al-nasi'ah* refers to the time allowed to the borrower to repay the loan in return for addition (financial increment) (*nasi'ah* is related to the verb *nasa'a*, meaning to postpone, defer or wait). It makes no difference

whether the return is a fixed or a variable percentage of the principal, an absolute amount to be paid in advance or on maturity, or a gift or service to be received as a condition for the loan. This leaves no room for arguing that *ribā* refers to usury and not interest.

The discussion of *ribā al-faḍl* has arisen from the *ḥadīth* requiring that if gold, silver, wheat, barley, dates and salt are exchanged against themselves they should be exchanged on the spot and be equal and alike. Of the six specified commodities, gold and silver unmistakably represent commodity money whereas the other four represent staple food items. The *fuqahāʾ* have over the centuries debated the question of whether *ribā al-faḍl* is confined only to these six items or if it can be generalized to include other commodities. Given the wide use of gold and silver as commodity money, the general conclusion is that all commodities used as money enter the sweep of *ribā al-faḍl*. With respect to the other four items there is a difference of opinion.

Imam Razi⁶ himself posed the question of what was wrong with charging interest when the borrower was going to employ the borrower funds to earn a profit. His well-considered reply to the question was: 'While the earning of profit is uncertain, the payment of interest is predetermined and certain. The profit may or may not be realised. Hence there can be no doubt that the payment of something definite in return for something uncertain inflicts a wrong (*ḥarām*)'.

The absolute prohibition of interest in the Qur'ān is a command to establish an economic system from which all forms of exploitation are eliminated, in particular, the injustice of the financier being assured of a positive return without doing any work or sharing in the risk, while the entrepreneur, in spite of his management and hard work, is not assured of such a positive return. The prohibition of interest is therefore a way to establish justice between the financier and entrepreneur.

Difficulty in understanding the prohibition arises from lack of appreciation of its place in the whole context of Islamic values, and particularly Islam's uncompromising emphasis on socio-economic justice. Any attempt to treat the prohibition of *ribā* as an isolated religious injunction and not as an integral part of the Islamic economic order with its overall ethos, goals and values is bound to create confusion.

Gharar

The *Shari'ah* determined that in the interests of fair, ethical dealing in commutative contracts, unjustified enrichment should be prohibited. This policy precludes any element of uncertainty or merely speculative risk (*gharar*). Generally, the unanimous argument of the jurists on this matter is that by failing or neglecting to define any of the essential pillars of contract relating to the consideration or the object, the parties to the transaction take an avoidable risk. This kind of risk was deemed unacceptable and tantamount to

speculation due to its inherent uncertainty. Speculative transactions are prohibited on the basis of *maysir*, *gharar* and *ribā* (Rayner, 1991).

In order to avoid *gharar*, the contracting parties must (a) ascertain that both the subject and prices of the sale exist, and are able to be delivered; (b) specify the characteristics and amounts of the counter values; (c) define the date of future delivery, if any (Ray, 1995).

Maysir

The term *maysir* was originally applied to a pre-Islamic game of arrows in which seven participants gambled for shares of an allotted prize. The prohibition of *maysir* arises from the premise that an apparent agreement between the parties is in actuality the result of immoral inducement provided by false hopes in the parties' minds that they will profit unduly by the contract. Little consideration is given by the parties to the risk of loss nor would it be likely that they would participate in gambling contracts in the expectation of loss.

This prohibition was extended by the jurists to cover all speculative and aleatory contracts, and also those where the obligations or advantages of either party are not fully defined at the time the contract is entered into. (It is upon the prohibition of *maysir* and *gharar* that the Western concept of insurance is forbidden in Islamic law.)

Despite the Qur'ānic imprecision of the concept, the legal classification of *maysir* was unassailable. It was left to later jurists to apply the term to particular kinds of gambling, whether for a prize or betting for a stake. They did this by extending and extrapolating the Qur'ānic prohibition to apply comprehensively to risk-taking and gambling (*qimār*) on the basis of certain authoritative statements attributed to the Prophet Muḥammad, *ṣalla-llahu 'alaihi wa sallam*.

The jurists drew the simple conclusion that if a given activity could be declared to be or in some way defined as *qimār*, it was clearly illegal. The moral principle upon which the legal objection to gambling is based is that even if a game of chance does not constitute fraud, the winner does not earn whatever he wins and the loser loses by mere chance (Rayner, 1991).

Forbidden contracts/elements

A number of barter arrangements peculiar to pre-Islamic market trading was expressly forbidden by the Prophet Muḥammad (*ṣalla-llāhu 'alaihi wa sallam*). The characteristic they have in common is that they depend on conjectured or uncertain definition of the goods being traded. It is from the explicit prohibition of such barter arrangements that Islamic law developed its strict rules about definition of the objects (and terms) of contract. Examples of forbidden contracts are:

- *Muzābana*: the exchange of fresh fruits for dry such that the quantity of the dry fruit is measured and fixed but the quantity of the fresh to be given in exchange is estimated while still on the trees.
- *Muḥaqaḻah*: the sale of grains still growing (that is, unharvested) in exchange for an equal quantity of harvested grains. (The prohibition of this particular transaction is an important element in the general discussion of *gharar* (uncertainty), the basis of the prohibition of futures trading in grain and other foodstuff and stock commodities.)
- *Mulāmasah*: an historic sales contract in which the sale was finalized with the buyer or seller touching a piece of cloth.
- *Munābudhah*: an historic sales contract in which the sale was finalized with the buyer or seller throwing a piece of cloth towards the other.

Financing techniques

One thing to remember is that not all increase, profit or gain is unlawful according to *Shari'ah*, but only *ribā* as previously defined and as understood by the various schools of law. This is emphasized clearly by the Qur'anic verse 'But God hath permitted sale and forbidden usury' (11: 275). Islamic jurisprudence permits a wide range of contracts to be designed and implemented within the principles of *Shari'ah*. Some of these techniques were developed in the period of the first Islamic state, others have emerged recently to meet contemporary financing requirements in the light of the teachings of Islam (Iqbal and Mirakhor, 1987).

Qarḍ ḥasan

Shari'ah distinguishes between two types of loan. '*Ariya* is a loan for use, which transfers the usufruct of a property temporarily and gratuitously to the borrower, while ownership of the loaned object remains with the lender. Either the lender or the borrower may rescind the contract at will and terminate the loan. The second type is the *qarḍ*, which involves the loan of fungible commodities, that is, goods which may be estimated and replaced according to weight, measure or number. In this case the borrower undertakes to return the equivalent or like of that he has received. The most likely object of a *qarḍ* loan would be currency or other standard means of exchange (Saleh, 1992), a pure loan transaction in which the client obtains cash from individuals or institutions, for example, a bank, to be returned at a stipulated future date, free of interest (Ahmad, 1987a).

Certain scholars allowed the lender to charge against costs incurred by him in making the loan available to the borrower. The service charges are not profit; they are actual costs in respect of such items as rental of premises, workers' wages, stationery. Islamic law allows a lender to recover from the

borrower the costs of operation over and above the principal (IFA, 1986), but an important condition attached to such charges, to prevent them becoming equivalent to interest, is that the commission or charge cannot be made proportional to the amount or to the term of the loan (Ashker, 1987). This is used mainly by the Islamic Development Bank when it grants loans to the government. Such service fees do not exceed 2.5 per cent and have been within the range of 1–2 per cent in recent years.

Profit-sharing and risk-sharing

The rationale of the principle of no profit-sharing without risk-sharing (*al-ghunm bi-l-ghurm*) is that earning profit is legitimized by engaging in an economic venture and thereby contributing to the economy (Ahmad, nd). The traits that distinguish Islamic economy and finance from their conventional counterparts reflect a different understanding of the value of capital and labour. In lieu of a lender-borrower relationship, Islamic finance relies on equitable risk-sharing between the person who provides the capital and the entrepreneur. This practice derives from the central tenet of Islamic banking based on the Qur'ān: the prohibition of *ribā*. Along with distributive justice, the rationale for profit-sharing also embraces allocative efficiency, economic stability and growth. As regards allocative efficiency, it is contended that debt financing usually goes to the most creditworthy borrower and not necessarily to the most productive and potentially profitable projects. As for stability, the argument is advanced that an interest-based economy has a built-in tendency towards inflation because the creation of money is not linked to productive investment. By contrast, in the Islamic banking system, so Islamic economists claim, inflation will be at its lowest, since the monetary supply will be proportionate to and correlated with economic activities. For example, *mudārabah* and *mushārahah* techniques finance production not consumption and so will not contribute to inflation (Khan, 1988).

Mudārabah

This is a financing technique in which the owner of capital provides funds to the capital-user for some productive activity on the condition that profits generated will be shared between them. The loss, if any, incurred in the normal process of the business and not due to neglect or misconduct on the part of the capital-user is borne by the capital-owner. The user does not invest anything in the business except his human capital and does not claim any wage for conducting the business. The ratio in which profits are distributed is fixed and predetermined, and known in advance to both parties. In the event of loss the capital-provider loses his capital to the extent of the loss, and the user of the finance loses all his labour. The willingness to bear the risk of loss justifies a share in the profit for the finance-provider. The profit-

sharing ratio mutually agreed upon between finance-provider and finance-user is determined by market forces (Siddiqui, 1987). The finance-user (the client) guarantees to return funds only on two conditions: if he is negligent in the use of the funds or if he breaches the conditions of *mudārabah* (Iqbal and Mirakhor, 1987).

Mushārahah

This is a financing technique in which a capital-owner finances investment in another party's business. Additional finance is provided to the party (individual or group) which already has some funds for investment. The finance-provider provides the additional funds on the condition that he shares in the profits from the business. The ratio in which the finance-provider shares the profits of the business with the party receiving the additional funds is fixed and predetermined, and made known in advance to all concerned. The loss, however, will be shared in the exact proportion of the capital invested by each party. The profit-sharing ratio is left to be mutually agreed upon and may be different from the ratio in which the two parties (finance-provider and user) have invested in the total capital of the project. This is because the two parties may share the work of managing the project in any amount mutually agreed upon. Both parties are allowed to charge a fee or wage for any management or other labour put into the project (Khan, 1987). All providers of capital are entitled to participate in management but are not necessarily required to do so. The *mushārahah* is continuous if the partnership lasts as long as the business operates (Khan *et al.*, 1987).

These techniques (*mudārabah* and *mushārahah*) are very similar because the provider of finance shares the profits directly and is contracted to bear the losses, if any, to the extent of his investment. That is why these two techniques are often categorized together as profit-and-loss-sharing (PLS). In Islamic banking, with the replacement of interest by PLS from the return on the capital advanced by the banks, repayment depends entirely on the productivity of the projected enterprise (Siddiqui, 1987).

According to the logic of the theory, the norm for an Islamic bank will be to assess the profitability of a project and back those projects which promise the highest rate of profit, are the safest, and the most socially beneficial. Projects for funding through PLS are expected to be selected primarily on the basis of their anticipated profitability rather than the credit-worthiness of the borrower. The relationship between finance and business is transformed. The interests of the two come together, with both needing to work jointly to create more wealth (Iqbal and Mirakhor, 1987).

But a pure PLS system has a number of positive qualities. Significantly though, the qualities that make PLS partnership so attractive to Islamic economists and entrepreneurs are the ones that make it so unattractive to Islamic banks. The bank does not know in advance its absolute income from the

transaction: by contrast, a conventional bank can work out the figure from the interest rate. The Islamic bank has to study and evaluate entrepreneurial proposals, a task requiring highly qualified personnel, and it has to find adequate measures to protect itself against manipulation of the profits which are to be shared. It has at the same time to offer its depositors attractive PLS projects, the financing of which will break even and quickly provide an income for the bank. From the point of view of an entrepreneur who is sure of a high profit rate, another practical drawback of the PLS technique is the sharing of the substantial anticipated profit. Paying out a fixed amount of interest is more attractive. This means that if purely economic considerations are paramount, and if Islamic banks are in competition with conventional banks, the Islamic banks will be left financing the less profitable projects. For all these reasons, Islamic banks have looked for other ways to employ funds, ways which do not involve risk-sharing and are economically profitable. The majority of actual transactions made by Islamic banks are, consequently, in trade financing, where mark-up and similar arrangements assure the banks of a more or less fixed return (Nienhaus, 1984).

Leasing/Ijārah

Leasing certainly is, or can function as, a financing technique. An individual short of funds may approach another with a surplus (the financier) to fund the purchase of a productive asset. The financier may do so by buying and renting it out to the one who needs the asset. This certainly is a financing technique in that the investor's financial difficulties (with respect to purchasing the required asset) are overcome. He pays only the rent and does not have to incur the capital investment involved in the purchase of the asset (Naseef, 1988).

To be acceptable in an Islamic framework, the leasing contract must meet certain conditions. The principal ones are the following (IDB, 1981c):

- the service that the asset is supposed to provide and for which it is being rented should be definitely and clearly known to both parties;
- the asset remains in the ownership of the lessor who is responsible for its maintenance so that it continues to give the service for which it was rented;
- the leasing contract is terminated as soon as the asset ceases to give the service for which it was rented. If the asset becomes damaged during the period of the contract, the contract will remain valid;
- the price of an asset that may be sold to the lessee at the expiry of the contract cannot be pre-determined. It can be determined only at the time of the expiry of the contract.

Payments to the bank must be made in instalments over a mutually agreed period. In the case of IDB deals, the title to the equipment is fully transferred

at the end of that period to the hiring company as a gift (IDB, 1981c). Banks provide companies with machinery and equipment under a joint-ownership agreement subject to conditions of security or surety (Ashker, 1987).

Hire purchase (Ijārah wa l-'Iqtinā)

This is a hire-purchase agreement between the bank and its clients. The bank agrees to buy and rent a building, equipment or other facility for the client, in conjunction with an undertaking by the client to make incremental payments into an account. At the end of each year, profits are added to the instalments paid until such time as the investment account contains the identical amount the bank paid to purchase the building equipment or facility. The client becomes owner of the financed equipment and the contract ends (Siddiqui, 1986).

Murābahah

This is a cost-plus contract in which a client, wishing to purchase equipment or goods, requests the Islamic bank to purchase the items and sell them to him at cost plus a declared profit (Ali, 1987). By this technique a party needing finance to purchase certain goods gets the necessary finance on a deferred payment basis. The finance-provider does the purchasing of the required goods and sells them on the basis of a fixed mark-up profit, agreeing to defer the receipt of the value of the goods even though the goods can be delivered immediately.

The need for finance of the one in need is thus met. He needed funds to purchase certain commodities (for example, raw material or capital goods, or even consumer goods). His purchase is financed, and paid for at some later date, though he may end up paying more than he would have paid if he had had his own money to purchase these goods. The desire of the finance-owner to earn income on his capital is also met. He makes profit in terms of the mutually agreed mark-up (Hamoud, 1985).

This financing technique is sometimes considered to be the same as interest – a person who needs, say, US\$1,000 to purchase certain goods gets the funds by eventually paying US\$1,100, which does look like paying 10 per cent interest. However, in theory, the mark-up is not in the nature of a compensation for time or deferred payment, even though the entire cost had to be incurred because the needy person did not have means at hand to make the purchase he wanted. Rather, the mark-up is for the services that the finance-owner provides, namely, seeking out and locating and purchasing the required goods at the best price. This is a recognized service which can be paid for and whose value is predeterminable. Furthermore, the mark-up is not related to time since, if the financed person is unable to pay in time as

agreed, the amount of the mark-up remains as fixed in the contract; it does not increase due to delay in payment (Khan, 1988).

Consider the position of the finance-provider. What justifies his earning the fixed mark-up? First, he provides a definite service in the form of obtaining the goods for his client, for which service he can charge a fixed price. Second, in obtaining the goods, he is taking a risk. The client may not accept the quality or price at which he purchased and the financier is then stuck with the goods. This risk is over and above the risks normally involved in trading activity, such as storage costs and damage in storage or in transit. All these risks justify his earning profit; they also mean that, though he has fixed the mark-up, he may not necessarily end up making a profit or getting the rate of return on his capital equal to the amount of mark-up fixed at the time of the contract (Khan, 1988).

The *murābahah* type of contract suggests a difference in price familiar in conventional economics as the difference between cash price and credit-sale price. The question normally arises: under the *Shari'ah*, is a seller allowed to charge a higher price for a credit sale than for a cash sale (Khan, 1988)? The short answer is yes, but three conditions must be satisfied beforehand: the buyer must be told that the price is a credit price, and the difference between the credit and cash price be made known to him; the buyer must be given the option of buying at either price; and the transaction must be a trade transaction (as distinct from a purely financial one).

The last condition introduces a particular distinction between the time-value associated with trade transactions and the time-value attached to purely financial transactions. While the former is permissible, the latter is not. Time has a value when it is associated with trade transactions in particular, but it does not have a value when it is associated with purely financial transactions. In trade credit, the difference between credit price and cash price varies with the profitability of the business. The relationship is also different between different industries and different businesses. In this respect, such contracts are not at all like credit contracts based on interest. Interest does not vary at all, being independent of the monetary value of the transaction, and independent of the goods or services transacted.

'Ushr

The meaning of '*ushr* (pl. '*ushūr*')⁷ is a tenth. As a technical term, '*ushr* refers to the *zakāh* levied on agricultural produce. The authority to impose this tax comes directly from the Qur'an: 'Eat of their fruit in their season, but render the dues that are proper on the day that the harvest is gathered' (6: 141). The rate of '*ushr* is one-tenth of the produce if the land is irrigated by rainfall and one-twentieth of the produce if the land is irrigated by a well.

Banks and financial institutions can meet the financing needs of trade and industry on the basis of *mushānraḥah*, *muḍarabah*, *murābahah* and *ijārah*.

But doing the same for the agricultural sector, still in accordance with the *Shari'ah*, presents a formidable challenge. The objective, to improve productivity of the land and labour is impossible without providing institutional credit to subsistence farmers. The following instruments may be used, compatibly with the *Shari'ah*.

Bai' Mu'ajjal

This literally means sale on a deferred-payment basis. Delivery of goods, inputs or implements is made immediately and the price agreed is paid by the purchaser at a given date in the future. The price includes the cost, plus a reasonable margin of profit to cover the administrative cost. The concept is based on a mark-up in price and is also known as *murabahah* (see p. 20). As the bank sells to farmers inputs and implements on a deferred payment basis, the transaction is a sale and not a loan. The *Shari'ah* permits a trader to sell goods for cash or on credit on the condition that the price, once agreed between the parties at the time of bargain, is not changed even if the payment is not made at the due date. Mark-up on mark-up, that is compounding the amount of profit, is not permitted. If this condition is not fulfilled or is violated, the transaction degenerates into *riba*. If secondary mark-up is not avoided, the objective of eliminating interest is not defeated, rather interest enters the transaction along with roundabout, tedious and time-consuming procedures. *Bai' mu'ajjal*, in a form acceptable according to the *Shari'ah*, lacks any deterrent for defaulters. The only guarantee of timely payment is the creditworthiness of the purchaser. This defect can be countered by enacting suitable laws allowing for the imposition of monetary fines on malicious defaulters. According to some scholars the amount of the fine on recovery must be deposited in the government treasury and not used as income by the seller (Zaidi, 1983).

Bai' Salam

The term *bai' salam* means advance payment or forward buying and is authorized by the Prophet Muhammad (*ṣalla-llāhu 'alaihi wa sallam*). The *salam* contract is the sale of a good to be delivered to the purchaser at a future date, which must be set at the time of the contract.

The conditions for the validity of such future sales are that the goods are not available or cannot be delivered at the time of contracting; and that the consideration in lieu of advance payment must be paid, or the rate of it fixed, at the time of concluding the contract. Failure to meet these conditions invalidates the contract. A *salam* contract is also void if the buyer's consideration is in the form of a set-off or negation of an existing debt.

The jurists added the further condition that any fungible object of a *salam* sale must be determined precisely as to kind, quantity and quality.

(Non-fungibles, such as precious stones, valuable paintings and so on, which are unique, cannot by their nature comply with the condition of determination and are therefore not permitted to form the objects of *salam* sales. Risk therefore generally stays with the seller until the time of delivery.) The purchaser in a *salam* contract has a right of inspection and may reject the goods on sight if they do not agree with their description as specified at the time of contracting.

Like *bai' mu'ajjal*, *bai' salam* is a trade transaction and not a loan transaction: the buyer (financier) agrees to purchase a commodity from the producer in advance and pays the agreed price immediately for the commodity to be delivered at a future date (Qudah, 1981), both the kind, quality and quantity of the commodity, and the time and place of delivery being specified, along with the agreed price.

Bai' salam has no practical advantage over *bai' mu'ajjal* (Hawari, 1984). The main conditions, as agreed upon by the majority of Islamic jurists, emphasize that the price fixed in the contract must be paid in full in cash, immediately at the time of contract, that the delay before the goods are delivered must be a defined period, and that the goods must be of a type commonly available at the time fixed for delivery, that is, the contract may not specify delivery of goods from a certain plot or location (Hamidi, 1986). The point of these conditions is to protect the financier against unnecessary risk while enabling the producer to deliver the produce, if need be, from another source, provided the conditions of kind, quality and quantity are met.

For all that, Islamic banks have not availed themselves of this type of sale transaction to finance agriculture. The practical problems in using this instrument to finance great numbers of farmers can be easily imagined: taking delivery of the produce, assessing its quality, then storing and disposing of it.

Istiṣnā

This is a new concept in modern Islamic finance that offers a number of future structuring possibilities for trading and financing. It is basically a contractual agreement for processed goods and commodities, allowing cash payment in advance and future delivery, or a future payment and future delivery. This flexibility allows the bank to pre-sell to its clients for future delivery on a cash-on-delivery basis and then negotiate the purchase.

Clearly, *istiṣnā* trading opens the way to a number of new opportunities, including some form of futures contract trading of processed commodities, as it permits deferral of both ends of the contract: delivery as well as payment. It is currently being used for short-term working capital finance. It is the view of Bahar (1994) that *istiṣnā* will play a key role in the short-term investment

and working capital schemes in the future, replacing the *murabaha* as the short-term financing scheme, especially in its international application.

The financing techniques mentioned in this section require Islamic banks to study the economic viability of potential investments and to audit and supervise business operations financed by them with great care. In this respect, Islamic banks need to have or to engage more staff expertise than conventional banks.

Notes

1. This prayer is normally recited by Muslims after mention of the Prophet Muhammad's name; it is usually translated: 'May peace and the blessings of Allah be upon him'.

2. Some companions of Mu'adh b. Jabal said: 'When the Apostle of Allah (may peace be upon him) intended to send Mu'adh b. Jabal to the Yemen, he asked: "How will you judge when the occasion of deciding a case arises"? He replied: "I shall judge in accordance with Allah's Book". He asked: "(What will you do) if you do not find guidance in Allah's Book"? He replied: "(I will act) in accordance with the *Sunnah* of the Apostle of Allah (may peace be upon him)". He asked: "(what will you do) if you do not find guidance in the *Sunnah* of the Apostle of Allah (may peace be upon him) and in Allah's Book"? He replied: "I shall do my best to form an opinion and spare no pains". The Apostle of Allah (may peace be upon him) then patted him on the breast and said: "Praise be to Allah Who helped the messenger of the Apostle of Alla to find a thing which pleases the Apostle of Allah". This tradition shows that exercise of individual opinion and analogy in deciding a case not covered by the Qur'an and the *Sunnah* is allowed. The Companions of the Prophet (may peace be upon him) made a number of decisions on the basis of their opinion and by exercising analogy when they did not find any rule of law in the Qur'an and in the *Sunnah*. While making a decision in a case one should in the first instance search for the rule in the Qur'an, then in the *Sunnah*, then in the *ijma'* (consensus) of the community or of the Companions and in the last have a resort to exercising one's opinion and analogy. (Sunan Abu Dawud, by Ahmad Hasan, Chapter 1348: 3585).

3. Much of the information and some of the arguments follow closely those of Rayner (1991).

4. For example, if the dealers in a commodity refuse to sell it, despite the fact that people are in need of it, unless they secure a price higher than its known value, they must be compelled to sell it at a price equal to the price of an equivalent commodity (Qaradawi, nd).

5. The relevant saying of the Prophet Muhammad (*salla-llahu 'alaihi wa sallam*) is: 'Allah has cursed the one who takes *ribā*, the one who pays, the one who writes the contract, and the one who witnesses the contract'. The gravity of *ribā* as a sin may be grasped from the Prophet's equating it to committing adultery thirty-six times or indulging in incest with one's mother (Chapra, 1992). There is also the well-known report of his command in the Farewell Sermon given on Mount Arafat during the pilgrimage the year before he died: 'Remember that you will indeed reckon your deeds: Allah has forbidden you to take *ribā*, therefore all interest obligation shall henceforth be waived'.

6. Abū Bakr Muḥammad ibn Zakariyyā al-Rāzī (850–925/236–313 AH), one of the

greatest of Muslim scholars and philosophers. He was known in the West as Rhazes, and his medical science and chemistry works were widely translated and circulated. He was also a very great commentator on the Qur'ān.

7. The plural form of the word, *'ushūr*, is used as a technical term to refer to custom duties, first imposed in Islamic history by the second caliph 'Umar bin Khaṭṭāb, at the rate of one-tenth of the value of goods.

CHAPTER 2

Overview of Islamic Banking

Background

Over the last fifteen years there has been a rapid expansion of financial institutions that can be characterized as Islamic in that they do not deal in interest-based transactions. At present about 45 countries, encompassing most of the Muslim world, have some type of Islamic banking or financial institution (Iqbal and Mirakhor, 1987). It will be useful, before proceeding further, to distinguish Islamic banking from interest-free banking. Islamic banking has been defined as banking in consonance with the ethos and value system of Islam (Masri, 1981); interest-free banking, by contrast, is a narrower concept, denoting a number of banking instruments or operations which avoid interest. Islamic banking, the more general term, is expected not only to avoid transactions on the basis of interest but also to participate actively in achieving the goals and objectives of an Islamic economy. The size of the funds under management according to *Shari'ah* principles has not been researched scientifically, but the undocumented estimate among the people involved in the industry is between US\$30-\$70 billion. At present there are four countries which implement Islamic banking at a macro level: Malaysia, Pakistan, Iran and Sudan.

It was the theoretical discussions of, and articles on, Islamic economics and banking that led to the pioneering experiment in Egypt, begun in 1963 in Mit Ghamr, a town about 80 kilometres from Cairo. The experiment lasted till 1967, by which time there were nine banks in operation, including those in Cairo, with more than 250,000 depositors and a total of 1.8 million Egyptian pounds in deposits. These banks neither paid nor charged interest. They made profits for their depositors sometimes by financing business on a profit-sharing basis, but mostly by engaging in trade and industry directly or in partnership with others. They were barred from charging or paying interest although their charter made no reference to Islam or *Shari'ah* (Siddiqui, 1986). The success of attracting small depositors of the Mit Ghamr experiment in Islamic banking was short-lived, 'for political reasons' (Zineldin, 1990). Others say that the experiment did succeed but that, for political reasons, the name of the institution was changed to the Bank of Naser. After that, in the 1970s, the Islamic banking movement began again, in a professional way, to

establish banks which would work under Islamic law. The establishment of the Islamic Development Bank (IDB) is considered to have been the kick-start for the movement's second phase (Abdel-Haq, 1989).

All existing Islamic banks are relatively new, the oldest having been established only in 1973 (Nienhaus, 1988). There are currently five categories of operating Islamic banks, including:

- the Islamic Development Bank;
- those banks which operate in countries where the whole banking system has been converted to operating on Islamic principles and whose activities are overseen in some way by religious bodies (for example, Pakistan);¹
- those banks which operate in Muslim countries and which co-exist with interest-based banks (for example, Jordan, Egypt, Malaysia);
- Islamic banks in non-Muslim countries whose monetary authorities do not recognize their Islamic character (for example the Al-Baraka International Bank in London¹ and the Islamic Bank in Durban, South Africa); and
- Islamic banks which exist in non-Muslim countries whose monetary authorities do recognize their Islamic character (for example, the Faisal International Bank (FIB)² based in Copenhagen, Denmark, registered under the Danish Banking Supervisory Board).

Problems

Islamic economists believe that there are significant problems associated with research in Islamic finance, most related to the fact that Islamic finance is a new discipline.

1. It has uncertain boundaries and lacks the conceptual and analytical sophistication of conventional economics. Any pretensions aside, the real content of Islamic economics consists of Islamic reflections upon, or an Islamic approach to, concepts supplied from conventional economics, concepts like the theory of supply and demand or the theory of money. Islamic economics has not, at any rate not yet, generated general concepts distinct from these of conventional economics.
2. Islamic economics has only recently come to be used as a rationale for determining policy objectives and implementation; consequently, the data available for analysis are relatively limited (Yalcintas, 1987).
3. There is a shortage of scholars sufficiently qualified in both the relevant disciplines, Islamic jurisprudence (*fiqh*) and conventional finance (Zarqa, 1987).
4. As a result of the shortage of relevant data and qualified personnel there is a retardation of the theoretical development of the discipline: theoretical analysis of the practical implementation of Islamic finance lacks the methodology, the tools (concepts, specialist terms) needed to proceed confidently and at pace (Ahmad, 1987b).

5. There has been a failure to establish modes of reasoning which will allow, for a particular problem, the relevance of arguments from the *fiqh* or from conventional economics to be determined (Zarqa, 1987). Conventional economics is not irrelevant to either the theory or the implementation of Islamic economic policy, and may, in some ways, be of great service (Abdul-Jabir, 1987).
6. The lack of criteria for determining whether a whole theory of all possible economic relations or transactions is needed, or if Islamic economics could or should confine itself to particular sectors of the economy or to particular sorts of transaction (Abdul-Jabir, 1987).

Islamic banks and *ribā*

The interpretation of the prohibition of *ribā* has in practice been subject to great controversy. Are fixed-interest loans preferable to those subject to interest-rate variations, so that the borrower knows at least the exact charges in advance and there is no element of uncertainty? Under inflationary conditions, should interest rewards be allowed to compensate savers for the depreciation in the value of their savings? A prohibition of nominal interest to compensate for inflation would penalize lenders and subsidize borrowers. It could be argued that the prohibition of *ribā* applies to real interest, not to nominal interest; as with inflation, a ban on the latter may result in negative real interest (Baldwin and Wilson, 1988).

A key element in understanding the theoretical framework of Islamic banking is understanding how Islamic banks can operate without paying or receiving interest (*ribā*). The Islamic bank should operate on the basis of profit. Islamic banks can earn profits in three areas: trading; leasing; and by direct financing in PLS contracts (Khan, 1988). The banks are free to devise instruments to earn profit in any of these ways provided that the structure and conditions of the transactions are in conformity with the *Shari'ah* and fulfil its desired objectives. Such a principle implies that Islamic banks can extend loans only if interest or return are not earned on it.

Consumption activities could be financed only, if at all, through cost plus the principal, as there is no profit to be earned or shared. As commercial institutions, the banks will advance money for commercially productive activities on the basis of profit-sharing principles. Even if they set aside some funds for consumption loans, the Islamic banks will be ignoring the needs of quite a large class of people for such loans. Clearly, other institutions will have to be developed to meet this need.

As explained, the rationale of the principle that there should be no profit-sharing without risk-sharing (*al-ghunum bi-l-ghurm*) is that the justification for earning profit is having engaged in an economic venture and thus contributed to the economy (Ahmad, 1987a). Depositors are regarded as shareholders of the banks or shareholders in a particular deal. Consequently, they are not

guaranteed a nominal value or a predetermined rate of return on their deposits. If the bank makes profit, the depositors are entitled to a share corresponding to their investment; similarly, if the bank incurs a loss, the depositors share it and receive a negative rate of return. To remain consistent with religious strictures, banks cannot charge interest on their lending operations but must use other modes of investment and financing, also based on profit-and-loss-sharing (Iqbal and Mirakhor, 1987).

Theoretically, Islamic banks should provide capital to dynamic entrepreneurs who have good projects but cannot offer collateral, and so create new businesses and thus contribute to the community's economic development (Nienhaus, 1988).

Islamic banks will always be at an instrumental disadvantage compared to conventional banks. If the Islamic banks develop new financial instruments, conventional banks are not prevented from adopting their practice if they judge it profitable. By contrast, Islamic banks cannot adopt all the instruments available to conventional banks (Nienhaus, 1988).

The Islamic bank is a mix of commercial bank and investment bank. Due to the nature of their investment operations Islamic banks have to devote substantial resources to develop viable projects. Due to the nature of their investment and their contractual relationship with potential users, they have to devote substantial resources to credit evaluation and appraisal of projects for investment.

As well as being compatible with Islamic norms, the banking operations adopted must be viable (profitable overall) because the system should be such as to protect the depositor and give him an adequate rate of return (Ahmad, nd).

Some Muslim writers suggest that because of the special importance of the financial intermediation sector in the Islamic economy, and its great influence, the sector should be nationalized (Naqvi, 1981). The view is not popular, however. Nationalization in general is not an authentic Islamic policy; it violates the basic Islamic philosophy of free will and respect for private property.

Four principles are of particular importance for Islamic banking (Mirakhor, 1988):

- there must be some risk, whether funds are used in a commercial or productive venture;
- all funds should preferably finance socially productive activity;
- financial risk must lie solely with the lenders of the capital and not with the manager or agents who work with the capital; and
- interest is forbidden in that it is a predetermined, fixed sum owed to the lender irrespective of the outcome of the business venture in which the fund is used.

The general objective of Islamic banks is to develop the economy within and according to Islamic principles. In no eventuality, therefore, can such

banks engage in the alcoholic beverage trade, in the payment or receipt of interest, in the gambling industry or in the pork meat trade, or in any other explicitly prohibited activities, even if such activities were conducted under a profit-and-loss-sharing contract (Khan, 1983).

The nature of financing

Financing modes can be distinguished according to the nature of the financing involved in different techniques. *Bai' mu'ajjal*, *bai' salam* and mark-up-based modes can be regarded as debt-creating modes of financing since financing in these three modes is in the nature of a debt. The finance-user stands obliged to pay back the entire financing (or its equivalent as agreed in *bai' salam*). The repayment by the finance-user is, in fact, predetermined and hence becomes a sort of debt from his point of view. On the other hand, *muḍārabah* and *mushārahah* are not debt-creating modes, in the sense that the user is not obliged to pay back the total amount of finance. To some extent *ijārah* can also be regarded as a non-debt-creating mode of financing. In *muḍārabah* and *mushārahah*, the finance-user pays according to the profits or loss that he makes out of the use of the finance, while in *ijārah* only the rent is paid which, for any individual user, may be a small part of the total value of the asset (Khan, 1988).

The time-value of money

A number of Islamic scholars have tackled this question (notably Khan, 1988). They start by arguing that *bai' mu'ajjal* and *bai' salam* (see pp. 17-18) are permissible modes of trade in Islam. In this type of sale, it is permitted that the price of a commodity sold, respectively on a credit or advance-payment basis may be different from its spot price. The *Shari'ah* does therefore recognize a difference in value due to a time element, and does not prohibit realizing the time-value of money. What is prohibited is any claim to the time-value of money as a predetermined quantity calculable at a predetermined rate.

Time is considered as malleable capital. The realization of time-value requires waiting for the outcome of the use of the assets (physical or monetary) over time. If that outcome over time is visible and tangible, it may justify a time-value of money; if the money has been used for mere consumption purposes, however, the money-owner is not entitled to claim a time-value for his money. The subject cannot be fully expounded here, but there should be no confusion with the concept of rent. It might be argued, for example, that rent includes a time-value of money and, since rent is predetermined, a predetermined time-value of money must by analogy be permitted in Islam also. This is incorrect. It is indeed true that the rent of an asset is calculated in a way that will realize not only the value of the asset but a certain monetary

time-value as well. But this calculation is made over the life of the asset, which life is in principle uncertain, nor is it necessarily the case that an asset will earn rent continuously throughout its life. Hence, how much time-value of money is actually realized remains uncertain until the asset has completed its economic life.

Two related points which need clarifying here: the argument that an uncertain rate of inflation makes the real rate of return on an interest-based loan a risk-bearing investment is not acceptable in Islam. Once we call it a loan, nothing can be charged on it irrespective of whether inflation or any other consideration makes the charge positive or negative in real terms. All financing is termed a loan when the principal remains guaranteed whether in nominal or real terms (Khan, 1988). In mark-up-based financing, the financier faces all the costs and risks normally involved in trading activity, such as locating and buying goods, storage and damage in transit. Furthermore, the finance-provider also runs the risk that the goods purchased for the finance-user may not be finally accepted by the latter on account of quality or other reasons. It is such risks that, in principle and in reality, keep the rate of return uncertain until the goods have been handed over finally to the finance-user.

The social-ethical dimension

Economics and ethics

If one examines the balance of emphasis in the publications in conventional economics, it is hard not to notice the eschewal of serious normative analysis and the neglect of the relevance of ethical considerations in the characterization of actual human behaviour (Sen, 1991).

In Islamic economics it is clear that economic considerations are subordinated to moral considerations, as for instance in the Qur'anic verse prohibiting *ribā* (interest) wherein the practice is described as gross injustice. The general requirement is that both the ends and the means must be Islamically legitimate (Naqvi, 1981). Beyond that, great emphasis is laid on maintaining a balance between the conflicting interests of individuals and the different sections of society (Zaman, 1991).

The relevance of Islamic banking to ethical banking generally is that it offers a number of alternative approaches to the banker-customer relationship. It helps to stimulate new ideas for alternative banking in the context of seeking ethical solutions to emerging problems, such as coping with the problem of how to help the society by financing small businesses based on networks or communes. If a small business applied to an Islamic bank for finance, the bank would, in principle, decide whether or not to support the project on the basis of a cost-benefit analysis of the scheme, not on the basis of the collateral or the debenture.

Social responsibility

One of the clearest expressions of the duty of Islamic banks towards the society in which they operate is the public statement of the International Association of Islamic Banks (IAIB).

The Islamic banking system involves a social implication which is necessarily connected with the Islamic order itself, and represents a special characteristic that distinguishes Islamic banks from other banks based on other philosophies. In exercising all its banking or developmental activities, the Islamic bank takes into prime consideration the social implications that may be brought about by any decision or action taken by the bank. Profitability – despite its importance and priority – is not therefore the sole criterion or the prime element in evaluating the performance of Islamic banks, since they have to match both between the material and the social objectives that would serve the interests of the community as a whole and help achieve their role in the sphere of social mutual guarantee. Social goals are understood to form an inseparable element of the Islamic banking system that cannot be dispensed with or neglected. (IAIB, 1990)

This statement represents the core of what the theoretician of Islamic banking expects Islamic banks to do in terms of social responsibility.

The duties of an Islamic bank and zakāh

This relationship can be best understood if we consider the following (IAIB, nd):

- Being part and parcel of the society, the bank must shoulder the responsibility that results from continual contact with the people, and create a genuine Islamic ethos.
- *Zakāh* constitutes an indispensable part of the fabric of the Islamic economy.
- The function of *zakāh* is primarily socio-economic; it aims not merely to satisfy the hunger of a poor man or to help him with a few pounds but to enable him to support himself by his own efforts so that he may have a fixed source of income. This rescues the individual from the indignity of dependence on others, or even on the state, for a livelihood. *Zakāh* funds supply craftsmen and merchants with enough resources to carry on their work and support their dependants. As each disease has its specific medicine, so *zakāh* is the medicine for poverty. A *zakāh* fund must therefore be established in each Islamic bank in those countries where the ruler takes charge of collecting alms. The Islamic bank can then play a technical assistance role in the government's fight against poverty.

Social activities are emphasized among the responsibilities of Islamic banks, and expressed explicitly in their articles of association. Among other objectives, the Jordan Islamic Bank for Finance and Investment (JIB), for example,

has stated that it will put special emphasis on introducing services designed to revive various forms of collective social responsibility on a basis of mutual benefit (JIB, 1978).

Social services are performed by an Islamic bank through its capacity as an agent of *zakāh* funds. The bank receives *zakāh* from *zakāh*-payers and holds these funds separately from its other sources and interest-free loans which are advanced by the bank in the form of overdrafts (Askher, 1987).

Production and consumption norms

Three categories of products are distinguished: necessities, conveniences and refinements (Ahmad, nd).

Necessities are all activities, services and goods essential to the preservation of the five Islamic foundations of sound individual and collective life, namely religion, life, mind, offspring, property. Conveniences are all activities, services and goods not vital to the preservation of the five foundations but which are needed to alleviate or remove impediments and hardships. Refinements are those activities, services and goods that go beyond the limits of conveniences. They include whatever does not remove or alleviate difficulties but consist rather in adornments which brighten one's life or console it.

These categories, it must be remembered, are not closed. Changes in the mode of life may shift certain activities, goods or services from one category into another.

Going beyond refinements into prodigality and self-indulgence is considered in Islam as a disservice, for individuals and society alike, and is strongly disapproved (Zarqa, 1981). Islam does not encourage Muslims to seek to expand their needs, but to contain them at a disciplined level. It encourages moderation and modesty, condemns *isrāf* (spending wastefully) and *tabdthīr* (spending wastefully on unlawful things) (Ahmad, nd).

Central banks and Islamic banks

Since Islamic banks in fact form part of the banking systems in the countries where they operate they are naturally expected, like other banks, to come under the control of central banks (Qarni, 1990). As explained previously, Islamic banks differ from conventional banks as regards the nature of their relationship with their clients. In the case of Islamic banks the relationship is one of direct trading or participation and not that of lender/borrower. Furthermore, Islamic banks do not trade in debts as do conventional banks. Therefore, central bank regulation of Islamic banks, undoubtedly essential, can be expected to take into consideration the special nature of these banks as formulated in their statutes. A controversy has arisen recently about

whether it is necessary to devise special legislation for the regulation of Islamic banks or to make do with the rules applying to conventional banks in this respect (Radwan, 1990).

In some countries, for example Jordan and Malaysia, central banks have issued special legislation concerning Islamic banks. In other countries, central banks have issued special legislation concerning Islamic banks but refuse the term 'Islamic' (for example, Turkey, where they are called 'special finance houses'). Other countries, for example the UK, have not made any special provision.

There is a consensus among Muslim economists that the central bank should supervise the Islamic commercial bank. This supervision should not be confined to a formal audit of transactions but should encompass a material appraisal of the quality of management decisions especially with respect to the more risky PLS finance. One of the aims of this supervision is to protect the clients who have put their money into investment accounts against avoidable losses. Minimum reserve requirements are suggested for similar reasons (Nienhaus, nd).

Government and the economy

The major objective of Islamic government in relation to the economic life of the country is, according to (Abadi, 1977): to raise revenues in order to secure the administration of *Shari'ah* laws and norms, central among which is the achievement of a degree of distributive justice. This objective is served directly through the collection and distribution of *zakāh* revenues, and indirectly through maintenance of Islamic inheritance laws, which also ensure a measure of wealth division and circulation, through supervision of the different transactions and functions in which people engage, and provision of legal mechanisms to settle any disputes that may arise. It is also a function of government officials to ensure the freedom of the market from hoarding and monopoly and to guarantee standards (for example, in respect of coinage, weights, measures).

The role of government is recognized and affirmed in Islam. That role is a limited one, but one vital for the smooth running of an Islamic economy. Whenever a market fails to operate on its own, an Islamic government may step in to remedy the situation, using various policies at its disposal. The Prophet Muḥammad, *ṣalla-llāhu 'alaihi wa sallam*, used to inspect markets to check for business frauds and other market imperfections. Once he cautioned a fraudulent trader, saying: 'Whoever cheats is not one of us'.

From the Islamic point of view the government has to take responsibility for certain fundamental economic goals, such as the eradication of poverty, the creation of employment, the maximization of economic growth, the establishment of an equitable distribution system and of socio-economic justice

and the creation of an environment conducive to economic activity. The welfare functions of the government include moral and spiritual education as well as the material development of the economy (Jalaluddin, 1991).

Chapra (1981) summarizes the essential functions as: to eradicate poverty and create conditions for full employment and a high rate of growth; to promote stability in the real value of money; to maintain law and order; to ensure social and economic justice; to arrange social security and foster equitable distribution of income and wealth; to harmonize international relations and ensure national defence.

Religious regulation

In order for all dealings and activities of Islamic banks to conform to *Shari'ah* injunctions, the banks' statutes, deeds and all other foundation documents, stipulate expressly that all transactions carried out by the bank should be subject to the supervision of a religious committee or at least that of a religious counsellor. The committee members and the counsellors should all be chosen from among senior specialized religious scholars. Their opinions (rulings) are binding.

The supervisory committee has to give an opinion on every financial instrument used by banks as well as on any innovation in instruments or operations. It has also to prepare annual reports on the final accounts and financial statements⁴ for the consideration of the General Assembly of the Annual General Meeting (AGM) alongside conventional auditors' reports. The committee report should include the results of its investigation of all bank operations, confirm that these have been found to conform to *Shari'ah* provisions and fall within the range of operations already approved by the committee and for which religious rules and principles have already been laid down by the committee. Throughout the year, the religious committee gives rulings on all operations carried out by the bank unless already approved by the committee as standard operations.

A fundamental condition for an Islamic bank to become a member of the International Association of Islamic Banks (IAIB) is to have a religious committee or a religious counsellor for religious supervision, by way of guarantee of the bank's adherence to *Shari'ah* provisions (IAIB, 1990).

Banking services

Islamic banks accept deposits from their clients. Ismail (1992) identified four types of accounts: current; savings; general investment; and special investment.

Current accounts

Islamic banks accept into current accounts deposits from clients looking for safe custody of their funds, together with convenience and use thereof, on the

principle of *al-wadi'ah* (trust). The banks take permission from their clients to make use of their funds while these funds remain with the banks. The clients may withdraw a part or the whole of their balances at any time and the banks guarantee the funds of such balances.

All the profits generated by the banks from the use of such funds belong to the banks. For their part, the banks provide the clients with cheque books and the other usual services connected with current accounts.

Savings accounts

Savings accounts are similar to current accounts except that the banks may, absolutely at their discretion, reward the clients from time to time by returning a portion of the profits generated from their funds.⁵

General investment accounts

Islamic banks accept into general investment accounts deposits from clients seeking investment opportunities for their funds, on the principle of *mudārabah*. The deposits are held for a specified period. When operating fully, the Islamic bank intends to accept deposits with different maturities.

In basic *Shari'ah* terms, the Islamic bank in the case of these accounts is acting as entrepreneur, or borrower, and the clients are providers of capital, or lenders. Both agree on how to distribute the profits, if any, generated by the bank from the investment of the funds. At present, banks offer the distribution in the ratio of between 60–80 per cent to the clients and 20–40 per cent to the bank. This ratio of distribution may be varied from time to time. In the event of a loss in investment the client bears all the loss. The client, in most cases, does not participate in the management of investment of the funds.

Special investment accounts

In addition to the general investment facilities for accepting deposits from its ordinary clients, the bank may also selectively accept deposits from its wealthy individual or corporate clients in the form of special investment accounts. These accounts are also operated on the principle of *mudārabah*; but the modes of investment of the funds and the distribution of profits may be (and usually are) negotiated individually.

Fund management

Many Islamic banks have created a specific fund with its own relevant terms and conditions. These funds operate as trust funds which are considered as an item off the balance sheet. Creation of such funds has flourished in recent years since they improve the liability and maturity of the banks, provide the

investors with a variety of investment opportunities and provide the bank with substantial income to compensate for its role as *mudārib* or entrepreneur (borrower) under Islamic law. Banks most active in this area are Al-Rajhi, the Kuwait Finance House and the Faisal Islamic Bank of Bahrain. Usually they utilize funds in such areas as ship leasing and real estate.

In addition to the above accounts the banks offer the following services:

Correspondent banking services

Islamic banks offer services in the sphere of international trade and money transfers. They establish correspondent relationships with foreign banks to facilitate services to be provided on their behalf. In case of direct money transfers, no special relationship is needed beyond providing the correspondent bank with ready balances in a current account to meet such obligations. The correspondent bank can legitimately claim commission on these services. The Islamic banks may, however, ask the correspondent bank to add its confirmation to letters of credit opened on behalf of foreign suppliers to importers in the country where the Islamic banks operate. Suppliers usually ask for this as an added security for their payments. Either Islamic banks must keep huge surpluses in their account with the correspondent bank to meet such obligations or they must ask the correspondent bank to cover their obligations to the third party (the suppliers) while they seek to replenish their accounts with the correspondent bank. This amounts to taking (short-term) loans from the correspondent bank for which Islamic banks cannot agree to pay any interest. How do Islamic banks solve this problem? In some cases foreign banks agree to deal with Islamic banks on the basis of a mutual agreement, initiated and confirmed by a simple exchange of letters, to provide the latter with confirmation facilities up to an agreed ceiling without charging interest, should the accounts go into the red. In return for this consideration, Islamic banks undertake to keep a reasonable amount of cash in their current account with the confirming banks and they try to cover any debit as soon as possible.

Other

Islamic banks provide other normal banking services under various rules of the *Shari'ah*. It is sufficient to mention just a few, as follows: remittance and transfers; sale and purchase of foreign currency; sale of travellers' cheques; trustee and nominee company services; and safe-custody services.

Notes

1. For more details about Pakistan's experience see Iqbal and Mirakhor (1987) and Khan, M. A. (1992), see also Presley (ed.) (1988).
2. This bank surrendered its licence on 28 June 1993.

3. Previously called the Islamic Bank International (IBI).
4. Not all the supervisory committees prepare annual reports on the final accounts and financial statements; they approve the type of transactions generally, not each individual transaction.
5. Some Islamic banks consider this sort of account to be in the category of investment accounts rather than savings accounts.

Al-Baraka International Bank Limited (AIBL): The Experience of an Islamic Bank in England

This chapter examines the phenomenon of Islamic or interest-free banking in the context of the Western financial system in England through the study of Al-Baraka International Bank Limited (AIBL), a subsidiary of Al-Baraka Group whose major shareholder is Mr Saleh Kamel. It discusses the objectives, functions and methods of fund collection and utilization, and how far Islamic values shape strategic goals and select priorities; it also reviews the supervision and evaluation of AIBL's financial position and its management.

The presence of Al-Baraka Group in London was considered to be a pioneering experiment which could have allowed the Islamic banking movement to develop within the international banking system. As a result of its inability to comply with the 1992 requirements of the Basel Supervisors (who set out minimum standards of supervision for international banks, the main one being that all banks should have a home supervisor capable of exercising effective overall supervision,¹ AIBL surrendered its authority to take deposits. Nevertheless, it provides an interesting study.

Perhaps the biggest obstacles facing the bank were excess liquidity and a lack of investment opportunities which were Islamically acceptable and profitable.

A profile

In 1992, there were 525 authorized banking institutions and incorporated institutions resident in the UK but registered outside (*Almanack*, 1992). Of these, AIBL was the only bank or deposit-taking institution which claimed to work under the Islamic banking code.

Objectives

The evidence tends to suggest that Mr Saleh Kamel decided to enter the UK market in order to expand Al-Baraka Group's international business and look for new markets; to complement and extend full services to foreign branches, subsidiaries of home clients and other corporations; to have some representation in one of the world's financial centres; and because of the convenient geographical location (Junejo, 1989):

In an interview, Al-Baraka Chairman Mr Saleh Kamel said that 'the reason why we opened AIBL in London was that we did not have a unit in any of the rich countries, so we decided to have two units, one in London and the other one in Bahrain'.

AIBL's objectives as they appeared in the official leaflet distributed to the group's clients, are as follows:

- to invest AIBL capital and depositors' funds in a correct Islamic manner to achieve the best possible level of *ḥalāl profit compatible with acceptable risk*;
- to provide individual and corporate clients with banking services conforming to *Shari'ah*; and
- to develop trading relations, particularly among Islamic countries.

Bank of England supervision

The Bank of England has two major duties: to supervise the institutions authorized by it; and to keep under review the operation of the Banking Act and development in the field of banking which appear to the bank to be relevant to the exercise of its powers and the discharge of its duties. As a supervisor the Bank of England must be satisfied with the capital, liquidity, management and corporate structure of every bank in London.

According to senior management interviewed within Al-Baraka, the Bank of England was concerned with the frequent changing of Al-Baraka's executives, and it was mentioned that the Bank of England had received complaints from Al-Baraka's customers about poor service and about mistakes that had occurred with their accounts.

The governor of the Bank of England, Mr Eddie George, addressed the Arab Bankers Association in March 1994 and discussed what the authors believe is the attitude of the Bank of England towards Islamic banking as follows:

I should like at this point to touch on another apparent source of misunderstanding and mistrust—our attitude towards what we tend to call Islamic banking. Now I know too that there is no single definition of what constitutes Islamic banking. But as I understand it, the basic principle is that making money out of money is contrary to Islamic law; that wealth should accumulate from participation in trade and the ownership of real assets. The Bank entirely respects that perception, and we can well see the connection with the teachings of the Qur'ān about social responsibility and cohesion. And even within a purely secular context we can understand how such an approach can help the financing of industry and trade. Some forms, at least, of Islamic banking not only can be accommodated within our system of banking supervision, but actually have been.

Nevertheless there are problems we have to solve together in facing requests that institutions be permitted to offer more general Islamic banking facilities here. One is how to classify Islamic funds in terms of our own legal framework. To what

extent, and in what precise forms, are funds placed with an Islamic institution capital-certain, thus falling within our Banking Act definition of deposits or to what extent are they participating in a collective investment scheme, falling under the Financial Services Act? My understanding is that Islamic funds may fall into either of these categories or indeed others, but we certainly need to deepen our understanding of the developing principles and practices in this area. But whatever form they take, I think it is likely that the concepts will be familiar to the supervisors and regulators here; and that we can find satisfactory answers to these questions, perhaps through the organizational structure.

A second issue is risk. In Western banking, a key method of managing liquidity, pricing risk and allocating credit is through the use of interest rates. The absence of interest in Islamic banking places a greater burden on risk managers within the Islamic banks. And Islamic banks' earning assets may tend towards the long-term and the illiquid, which may require the institution in holding higher levels of overall liquidity, with implications for its profitability. I do not believe that these are inseparable problems, either for the banks concerned or for their supervisors. For any institution supervisors will require assurance that risks are properly assessed and controlled, and that a bank has adequate resources in terms of management, liquidity, systems and capital. In this sense, from a supervisory perspective, Islamic products do not raise fundamentally different issues from any other banking product, be it swaps, options, syndications or whatever. But they do cause the supervisors to probe thoroughly for explanations that they fully understand. We are bound to do this as a matter of statutory duty, and it is right that we should – just as we are properly obliged to probe *all* the less familiar banking products.

Some central bankers in predominantly Islamic countries have argued that the central bank should itself be equipped to judge which kinds of contract are acceptable in Islamic law and which are not, and there is a supervisory case for this. For example a sudden perception that a bank was engaging in Islamically unacceptable business could put the bank's liquidity under strain. In this country we would expect all banks, as a matter of course, to take legal advice to ensure all contracts are legally sound under UK law; but we necessarily leave it to the banks themselves, and their *Shari'ah* advisers, to judge what is acceptable in terms of Islamic law, because the liquidity risks are proportionately much less here. Our role as supervisor is to judge what is prudent banking, and also what is acceptable in terms of the UK Banking Act, under which we have statutory responsibilities.

We can conclude that the Bank of England has not issued any special regulations for Islamic banks. It therefore treated AIBL as any other bank operating in England. The reason it gives for this is that there should be one law by which all banks are bound, whether or not a particular bank is a conventional institution, as long as they carry the word in their title.

As an Islamic bank, AIBL did not face major obstacles in satisfying the Bank of England on the question of capital adequacy and liquidity. The minimum requirement for a bank under the 1987 Banking Act is £1,000,000.² AIBL began with £5,000,000 at the start of its UK operations, a sum subsequently increased to £10,000,000. In 1988 the figure had risen to £30,000,000. Further capital of £15,000,000 was injected in 1990. On the other

hand, AIBL had to suffer from the absence of an Islamic investment market.

AIBL invested most of its short-term funds in the commodity market through other banks arranging with them to guarantee the contracts (Junejo, 1989).

Business relationships

With other Islamic financial institutions

AIBL conducted business transactions on Islamic principles with other banks and financial institutions. Some Islamic banks, especially those in the Middle East and other members of the Al-Baraka Group, saw that AIBL had the potential to become a reliable depository. Before its closure, however, AIBL had failed to prove that it could take on such a responsibility. Evidence from the 1991 Al-Baraka Annual Conference, held in Torquay, shows that during the Gulf crisis the Jordan Islamic Bank sought to transfer around US\$100 million to AIBL but the AIBL chief executive at that time refused to accept the deposit. His defence at the conference was that this was due to the lack of investment opportunities available to AIBL. Most of the participants, including the chairman, were not convinced by such an answer.

With UK-based conventional commercial banks, financial houses, merchant banks, security houses and corporate clients

AIBL established unilateral relationships with a number of conventional financial institutions (large merchant banks) to manage its short-term funds, mostly through investment in commodity transactions. Four executives working as heads of Islamic investment departments within conventional banks were asked to estimate the percentage of AIBL's money invested Islamically within conventional banks. The answer from all of them was 'around 80 per cent'. It would be understandable for regional Islamic banks to do these sort of deals, for reasons of distance and the difficulty of access to the international market, but for AIBL such deals defeated the object of its establishment. AIBL's failure to identify quality deals and its insistence on having guarantees from other banks to bear the risks does highlight the difficulties facing its management.

Fund collection

The main sources of funds available to AIBL came from shareholders and from depositors (through various forms of deposits). The following types of account were available with the bank:

Current account

This is the same as a conventional current account. AIBL provided all the current account facilities that a conventional bank offers (for example, cheque books and standing orders). No profit or return was offered on this type of account.

Bonus current account

This account is similar to the savings and deposit accounts in conventional banks. AIBL accepted deposits from clients and, as with the current account, was allowed to use the funds. AIBL guaranteed the principal deposit according to the regulations of the Bank of England. The main difference between the ordinary current and the bonus current accounts was that if the cleared balance maintained in the latter averaged £2,500 (the bonus level) or more for a period of six calendar months, a bonus would be credited to the account. The question is, how does this differ from payment of interest? According to *Shari'ah* we must differentiate between an obligation to add a certain bonus after a certain term, and a non-obligatory addition of a bonus. In the latter case, there is no violation of Islamic law. If, however, the depositor has a right to demand a bonus after a certain term, this amount is *ribā* and is considered a serious violation of Islamic law (Abdel-Haq, 1989).

Fixed-term deposit account

A minimum deposit of £500 or US\$1,000 was required to open such an account, whose funds were invested in accordance with the Islamic norms of *mudārabah*, *mushārahah* and *murābahah*. The minimum term was one month and the gross return to depositors was based on a percentage of the monthly profit-yield earned on the bank's investments, varied according to the period of the deposit as shown in Table 3.1.

The bank retained the remainder of the profit as its management fee. According to the chief executive at the time: 'In reality AIBL never entered into any deals unless there was a guarantee of profit-to this end it placed its money in one of London's commercial banks'. In the case of loss, AIBL never

Table 3.1: *AIBL percentage of monthly profit-yield*

Period	% of bank's monthly profit-yield earned by depositors per annum
Up to and including 3 months	75
Over 3 months, less than 6 months	80
Over 6 months, less than 1 year	85
Over 1 year	90

passed the burden of loss to its clients' deposits; the bank's shareholders absorbed the loss, not its clients' and that is one of the points which alarmed the Bank of England, which considered that this might be misleading to investors.

Specified deposits

This was a special form of term deposit designed for institutions or high net-worth depositors who were seeking a guaranteed income. It was invested on the international commodity markets or in trade finance on a *murābaḥa* basis through very reputable commodity dealers or banks. The transactions were closely monitored and approved by the bank in advance for compliance with the *murābaḥa* format. The repayment by the end-purchaser were usually supported by letters of credit by banks. Given the nature of *murābaḥa* transactions on an agreed predetermined mark-up, this meant that depositors knew in advance what profits to expect. The gross return to depositors was equivalent to 9.5 per cent of the profit earned on the related investment.

Other banking services

In addition to deposit accounts AIBL provided a number of services to its clients, on a commission or fee basis: standing instructions; special presentation for express cheque clearance; sale of travellers' cheques; investment management services; banker's references; and the buying and selling of foreign currency.

Function

The core function of a commercial bank is to enhance the taking of deposits or loans from people who wish to invest and then lending at a slightly higher interest rate to businesses or householders who wish to borrow. Islamic banks are not supposed to deal with interest rates, directly or indirectly. So what was the function of AIBL? In interviews, five executives and six managers who worked in the bank were asked whether they saw AIBL as a major developmental institution or as a profit-seeking organization. The answer given by eight interviewees was: 'We were a financial intermediary; we existed to maximize profit in a *ḥalāl* way, this was the key objective for us'. AIBL functioned as a financial intermediary and resource mobilizer like any other conventional bank but without contradicting Islamic law. Two former executives who worked at AIBL until its closure stated that Islamic banks came into existence originally to make a profit as well as for the developmental purposes of the society in which they were working; they existed in order to adopt profit-and-loss-sharing, instead of the interest rate, as a means of spreading social justice and fight unemployment. They went on to say that

what had happened to Islamic banks, including AIBL, was that instead of doing that, they had adopted conventional banking mechanisms in disguised form; they adopted mark-up instead of PLS to replace interest. The striking thing about the other executives and managers was that they were extremely sceptical of the whole concept of interest-free finance and inadequate legal support. In another interview, one executive went even further:

Islam does not recognize money as a commodity and as a consequence of that we do not have financial intermediate-bodies called banks in Islam-because that means recognizing money as a commodity which means there is a price for such a commodity, such as the interest rate, this definitely being prohibited in Islamic law.

In interviews with ten clients of AIBL, all believed that AIBL had a responsibility beyond making profit, specifically that AIBL had a responsibility towards the Muslim community in the United Kingdom. When asked the question, 'What do you expect from AIBL?', answers were varied: (a) some stated that AIBL should give more *qard hasan* (interest-free) loans; (b) some had expected AIBL to do PLS transactions; (c) others wanted AIBL to help students and needy people through *zakāh* funds.

The different views about the function of AIBL can be summarized as follows:

- AIBL functioned as a financial intermediary and was an Islamic profit-seeking organization like any other conventional bank but without violating Islamic law;
- AIBL was an Islamic profit-seeking organization with a social responsibility towards the society it operated in;
- AIBL could not work under Islamic law because Islamic Law does not accept financial intermediaries.

Priorities and conformity to Islamic values

How far Islamic values shape strategic goals, whether they can be translated into institutional forms that operate Islamically and whether or not Islamic transactions or investments can still be profitable from an economic point of view are the questions at the core of the following discussion.

While there is no particular law governing Islamic banking within the UK, AIBL claimed in its leaflets and its annual reports that it was working under Islamic law. It had a *Shari'ah* adviser in London as well as an expert *Shari'ah* consultant in Al-Baraka headquarters in Saudi Arabia. Both were consulted whenever the bank's management felt this was necessary.

In interviews with executives and managers at AIBL, and with selected clients, the question was put: what criteria influenced you in deciding whether or not to get involved in any new business? The answers were given willingly and without hesitation, and all interviewees said that the first thing they did was to ensure that a potential project did not contradict Islamic values. If it

did, all said they rejected it immediately. They were also asked whether they would have taken on a project which did contradict the *Shari'ah* but which was 100 per cent profitable. They all answered that they would never enter into any transaction which violated the *Shari'ah*.

Al-Baraka's chairman insisted in his speech at the bank's last annual conference, held in Torquay, England, in 1991, that all senior managers must refuse any deals which were unacceptable in Islamic law:

I do not want to find out that any of my colleagues, for any reason and under any circumstances, did any deal with anything which was not acceptable in Islamic law. We do not want any *haram* profit. I would like to be able to tell Allah on the day of judgement that all my investments were *halal*.

Despite good intentions there is always the chance that misunderstandings will happen from time to time. Thus, in 1991, for example, a memo was circulated by the senior manager asking branch managers to charge for any overdraft. Plainly this senior manager did not know even the basics of Islamic banking. Any extra money above the principal makes the loan a *riba* transaction which is forbidden in Islamic law. An employee raised this point with the chairman of Al-Baraka during one of his visits to London and the memo was withdrawn. Here we can see that not only was the chairman's directive ignored but that the *Shari'ah* consultant was not consulted, which raises the question of the limits of the responsibility and authority of such consultants in the bank.

As the relevant literature shows, social responsibility is a controversial subject. The concept is difficult to define and even more difficult to measure. Nevertheless, in order to make an assessment of AIBL's social responsibility, it was necessary to set some criteria, albeit imperfect, by which to do so. Therefore, it was decided, in the context of Islamic banking, to ask the following three questions which, if answered positively, would indicate whether a policy of social responsibility policy existed and how effectively it was being put into practice:

- Does AIBL conduct its business on a PLS basis, and if so, how much of its business?
- Does AIBL issue interest-free loans?
- Does AIBL fund or contribute to the development of social projects to help the Muslim community in the UK?

The responses were as follows:

- Q. 1. From the answers of five executives interviewed, it seems that AIBL had completely stopped dealing in PLS. (The reasons for this will be explained in the next section).
- Q. 2. AIBL annual reports 1986-90 show that AIBL did not have an interest-free loans policy.

- Q. 3. Responses in interviews showed that AIBL had not contributed to any development project for the Muslim community in England.

When the chief executive of AIBL was asked by us what criteria the bank used in its investment policies, he said: 'Once assured that the project does not violate *Shari'ah*, AIBL adopted the conventional banking investment criteria before taking any decision'. These criteria were: credit risk (for example, credit-worthiness and duration); return; complexity; administrative cost (documentation, monitoring); and how well the project fitted in with the bank's strategy and its other assets.

The adoption by AIBL of Islamic values as a code for its investments was considered to be a major constraint on the bank's investment activity. In interviews, former chief executives claimed that: '*Shari'ah* was one of our major obstacles faced by the bank, in that there were not enough investment products that were Islamically acceptable and profitable enough to allow AIBL to invest all the funds available'. Thus AIBL had a major dilemma which was confirmed by Nienhaus (1988) when he said:

Islamic banks will always be at an instrumental disadvantage compared to conventional banks. If the Islamic banks develop new investment instruments, conventional banks are not prevented from adopting their practice if they judge it profitable. By contrast, Islamic banks cannot adopt the instruments available to conventional banks.

From these interviews it became obvious that AIBL faced a dilemma: while the bank was trying not to make any deals which contradicted Islamic law, a restraint that caused it to lose a lot of investment opportunities, it was at the same time trying to match the conventional banks in terms of profit. This was confirmed in an interview with one of the AIBL executives. When asked, 'How do you determine the rate of profit on the investments you enter into?', he said: 'We take into consideration the current rate of interest and we work in parallel to it'.

Fund utilization

AIBL concentrated overwhelmingly on *murābaha* as a financial instrument for short-term use of funds, usually by purchasing a commodity for the client on a predetermined mark-up or profit basis. In the early stages of its existence, AIBL had dealt on a profit-and-loss-sharing (PLS) basis. Before 1990 the PLS contracts represented around 5 per cent of the total business of the bank.

There appears to have been a conscious decision to stop dealing in PLS contracts after a failure to achieve profit on this kind of contract. The chief executive and the credit officer admitted this. A particular issue was that there was a conflict between English and Islamic law concerning profit-and-loss sharing. In English law both capital owner and entrepreneur are liable for each other's debts for an unlimited amount, whereas in Islamic law liability

depends on the agreement alone. Hassan Kamel,³ Al-Baraka's chief executive, explained:

The depositors wanted an Islamic deal without risk. They liked, at least, to guarantee their capital. The problem with PLS is that they [the Islamic economists] assume the scenario of the entrepreneur being a good Muslim. Bearing in mind that *murabaha* does not fulfil the idea behind Islamic banks we should concentrate on finding a way to promote PLS transactions as viable contracts.

The placement of AIBL funds in short-term investments with the Islamic departments in conventional banks indicated that the bank was not able to expand its investment activities in the UK market.

As a consequence of the above, we can perhaps discern the gap between the theory of Islamic banking and AIBL practice: while the Islamic banking theory considers PLS to be the core of Islamic banking transactions (Siddiqui, 1988), the reality is quite different. AIBL had totally stopped dealing in PLS prior to its closure, for the reasons given.

Performance

Management

The main body which managed and supervised AIBL was its board of directors. The characteristics of the board were similar to that of any conventional bank. It is worth mentioning that the Bank of England attaches considerable importance to the role of non-executive directors, placing particular value on their ability to bring an independent perspective to the running of the business and to question the approach of the executive directors and other management. The Bank of England considers that non-executive directors have a particularly important role to play as members of an institution's audit committee (Penn, 1989). AIBL responded to this criterion positively and appointed two non-executive directors from outside Al-Baraka Group in the financial year 1991.⁴ The Bank of England also required the institution to conduct its business in 'a prudent manner', and to this end concern was given over the institution's directors, controllers and managers and whether they were fit and proper people to hold their respective positions (Penn, 1989).

When asked about the major obstacles which faced AIBL in London the former chief executives pointed to the following:

- the constraints of the *Shari'ah* itself. There were not enough investment products that were both Islamically acceptable and profitable enough to allow AIBL to invest all the funds under its management, so the bank had a cash surplus problem;
- the stringent requirements of the Bank of England;
- the lack of availability of experienced bankers within Islamic banking;
- the size of the bank's capital which was too small for competitive purposes.

The capital of the Lloyds branch next to us is bigger than the capital of AIBL', one chief executive said [note the contradiction between this and the first point and;

- the great competition from non-Islamic financial institutions.

When the last point was raised, the authors asked how AIBL competed with conventional banks. The answer was that AIBL did not compete with anyone. Apparently conventional institutions were competing with AIBL by opening Islamic investment units.

When the authors asked whether AIBL's banking operations and activities took more time than the same operations in conventional banks, the top management's view was that AIBL did take longer due to: lack of efficiency; more complicated instruments; not enough products; no standard form of operations and transactions; and no fixed investment criteria, each transaction was studied separately, which was time-consuming and therefore could be added to the cost of decision-making.

Senior managers were asked in addition whether there were any extra costs or operational expenses that the Islamic banks had to pay because they were Islamic. The answer was 'Yes', in what they called bank placements, especially with bank-to-bank business. When Al-Baraka Islamic Bank made short-term deposits in other conventional banks it had to ensure that the investment was Islamically acceptable. A senior banker in London said:

There is an extra cost to this which is borne by the Islamic bank. In the simpler bank-guaranteed placements through conventional banks, trading goods and merchandise is more expensive than placing them (conventionally) in the interbank deposit market.

Marketing and client services

To the question 'What were the advantages of being an Islamic bank working in London?', the chief executive answered that 'there were no advantages at all; rather there were a tremendous number of disadvantages, this is supported by the fact that over its last few years AIBL had seen some losses in financial terms'. But the evidence tends to suggest that it is most likely that the bank's losses were due to poor management and the lack of a strategy for penetrating or locating a niche in the market.

In an interview with one of the executives in AIBL we asked what the bank had been doing to attract more clients. The answer was increased advertising. But advertising alone is not enough. Drucker (1988) pointed out that advertising can succeed only if two vital ingredients are added to marketing techniques: the product or service has to give satisfaction to the clients as well as providing profits for the institution; and the product has to be offered in a place convenient to the clients.

The absence of a quality service is illustrated by giving a small example. At

one point there were no cheque books available for three months for the clients of AIBL (London) and the reason was that the officer responsible had simply forgotten to order them from the printing house.

When we interviewed ten of the bank's clients we asked them why they had deposited their money with AIBL. Eight of them said they had done so because it was Islamic. All of them said they were disappointed with the services and the treatment they got from the bank.

AIBL appears to have had between 11,000–12,000 depositors' accounts, distributed between its four branches. The choice of location for the bank's branches was largely dependent on the potential numbers of depositors in the Muslim community as well as on the economic activity of the area, according to the marketing director. In order to motivate and encourage depositors to stay with AIBL, the bank's policy of profit distribution was, as we noted earlier, to ensure that depositors never suffered loss; the loss, in its entirety, was transferred to the shareholders.

Financial performance

As confirmed by all senior managers and decision-makers in AIBL, the bank's aims were to maximize its return on invested capital in an Islamically acceptable way.

As is well known, the primary return of the conventional bank is from lending and investing deposits and shareholders' equity. As an Islamic bank AIBL could not earn any profit through interest, its funds had to be invested in non-interest bearing instruments so the earnings became *halal*.

AIBL's financial performance was not at all impressive. In the year 1990, for example, we find it suffered a 17.4 per cent loss (see Table 3.2).

In terms of growth of deposits, AIBL's record for the period 1986–90 appears to have been healthy. However, it was not possible, for lack of information, to examine how this growth was distributed among the various

Table 3.2: *A profile of AIBL's financial performance (£ sterling)*

	Capital	Assets	Deposits	Capital assets (%)	Pre-tax profits	Return on capital (%)	Return on assets (%)
1986	10,258,755	47,597,423	32,159,053	21.5	355,954	3.46	0.74
1987	10,225,601	64,309,195	46,075,478	15.9	(28,341)	(0.27)	(0.04)
1988	30,668,049	109,650,557	58,731,248	27.9	1,135,180	3.70	1.03
1989	31,316,484	136,136,657	87,321,663	23.0	1,148,105	3.66	0.84
1990	40,207,567	182,878,000	139,541,387	21.9	(7,016,000)	(17.40)	(3.83)

Source: Al-Baraka International Bank Limited, annual reports and accounts for 1986, 1987, 1989 and 1990.

Note: () means a loss was incurred.

deposit accounts. How much money had Al-Baraka Group and overseas companies related to the group contributed to the increase of deposits in AIBL? It is important to mention here that in the banking industry deposits can generally be classified as retail or wholesale. The latter are raised in large amounts from other banks and companies, enabling a bank to finance a sudden rise in investment opportunities. The former are raised from depositors through a branch network. This has the advantage of ensuring a high level of stability to the deposit base so that the bank is not at the mercy of a few large depositors (Close, 1988).

A number of sources claimed that more than two-thirds of AIBL's total deposits came from the companies and banks belonging to Al-Baraka Group. What does this mean? It means that the apparently healthy growth of the AIBL deposits was the result not of successful management in attracting new money and clients but of an increase in shareholders' money either directly or indirectly through their companies' deposits.

Tables 3.3 and 3.4 show comparative figures for 1985 and 1991 in terms of ratio of deposits to assets, ratio of capital to deposits, and ratio of investment revenue to total deposit and capital.

From these figures it may be seen that the ratio of deposits to assets (the proportion of deposits placed in investment assets) increased from 1985 to 1991 by 19 per cent, whereas the ratio of capital to deposits decreased by 14 per cent. The ratio of investment revenue to total deposit and capital decreased by 4.1 per cent. In comparing these ratios, we find that the increase in deposits and capital looked more like a burden and a disadvantage than an advantage. When questioned about the losses in 1990, and how this bad result could be

Table 3.3: *AIBL: A comparison, 1985 and 1991 (£ sterling)*

	1985	1991
Total assets	37,374,339	191,422,000
Total deposits	23,106,850	153,750,000
Capital	10,000,000	49,976,000
Total investments	33,000,000	183,000,000
Profit before tax	141,889	(68,851,000)

Source: The AIBL annual reports and accounts for 1985 and 1991.

Table 3.4: *AIBL: A Ratio's Comparison, 1985 and 1991 (£ sterling)*

	1985 (%)	1991 (%)
Ratio of deposit to assets	61.0	80.0
Ratio of capital to deposits	43.0	29.0
Ratio of investment revenue to total deposit and capital	00.4	-3.7

explained, the chief executive offered the following reasons: the very high costs of operating in London; great competition; and lack of qualified management.

This study of a pioneering experiment in Islamic banking suggests that the major challenges in operating Islamically in London do not differ from those faced by any other conventional bank and that being an Islamic bank does not imply that management, capital, liquidity and corporate structure are not as important as in conventional banking.

Notes

1. As the governor of the Bank of England mentioned in his speech to the Arab Bankers Association in 1994, there is no particular group of banks against which these measures are aimed.

2. Since January 1994 its ECU is 5 m – per 2 BCD.

3. Chief Executive of AIBL until his death in July 1995.

4. The two were: Lord Denman (director of Close Brothers Group plc (merchant bank) and former Director of the Saudi British Bank and the British Bank of the Middle East) and Owen H. Rout (chairman of Mercantile Group plc and Starmin plc, former executive director (UK) of Barclays Bank plc and former chairman of Barclays Financial Services Limited).

CHAPTER 4

The Jordan Islamic Bank for Finance and Investment (JIB): The Experience of an Islamic Bank in Jordan

This chapter examines the phenomenon of Islamic banking in the context of an Islamic country, taking the Jordan Islamic Bank for Finance and Investment (JIB) as a case study and discussing a profile of the bank, its supervision, function, and the extent to which Islamic values determine the bank's priorities, fund utilization and its performance.

As Presley and Wilson (1991) stated, the JIB is one of the most successful Islamic commercial banks at the retail level. It operates within a Muslim society, enjoys support from the monetary authority, and has prudent management. These and other factors have helped it to become the third among Jordanian banks in terms of deposits and assets. Perhaps the largest obstacle facing the bank is excess liquidity and a lack of investment opportunities which are acceptable Islamically and profitable. Overall, the experience of this bank suggests that Islamic banking in Jordan has the opportunity to grow and to be one of the major players in the Jordanian banking system.

Banking in Jordan

Jordan is among the middle-ranking economies in the Arab world. It had a nominal GDP of US\$4.58 billion in 1988 (*Economist*, 1990). It has a population of about three and a half million. With limited natural resources Jordan relies heavily on aid from fellow Arab countries and remittances from around 325,000 migrant workers to cover its chronic trade deficit. Jordan is not an oil-producing country; however, the oil boom in the Gulf helped Jordan by increasing employment for Jordanians in these countries, and it also increased aid from those countries.

In the early 1970s Jordan's banking and financial sector consisted of only a few commercial banks and state-controlled specialist financial institutions. Now it comprises at least 36 institutions. Such a rapid enlargement of this sector took place during the oil boom in the neighbouring Gulf countries when the volume of money to be handled ballooned due to increased aid and remittances. The first Islamic bank to be established in Jordan was the Jordan Islamic Bank which was set up in October 1978 in the form of a shareholding company.

Evidence suggests that until 1994 Jordan's economy was reliant upon external financial assistance (Wilson, 1990). Notwithstanding this, or Jordan's moderate size, it is one of the most advanced and progressive Islamic nations. The population of the country is certainly one of the best educated and best qualified of the whole Islamic world, especially with regard to banking, with the bulk of the population using banks. With the foundation of the JIB in 1978, the Islamic method of banking became firmly entrenched in the Jordanian financial sector. There is still fierce competition, however, within the financial sector, especially from the dominant interest-based banking spheres. In consequence of such fierce opposition the JIB is the only one of its kind in Jordan at the present time.

A profile of JIB

Establishment

The Jordan Islamic Bank is an associate member of the Dallah-Al-Baraka Group (the group shareholding is 40 per cent). It tends mainly to invest within Jordan (Wilson, 1984). In Jordan there is a plural system which accommodates both *ribā* and *ḥalāl* financial transactions. The Islamic banks are the only type permissible under *Shari'ah* Religious Law no. 13 of 1978, which was published in draft form in the official *Gazette* (No. 2733) on April 1978. It was this law which provided for the establishment of the JIB. The JIB, founded in 1978, has been operating since September 1979.

Objectives

As laid down in the Jordan Islamic Bank for Finance and Investment Law of 1985 the aims of JIB are: to meet economic and social needs in the field of banking services and investment operations on a non-usurious basis. In particular, these objectives shall include (JIB, 1985):

- Expanding the extent of dealings within the banking sector by offering non-usurious banking services, with special emphasis on introducing services designed to revive various forms of collective social responsibility on the basis of mutual benefit.
- Developing means to attract funds and savings and channelling them into non-usurious banking investments.
- Providing the necessary financing to meet the requirements of various sectors of the economy, particularly those which are not likely to benefit from usurious banking facilities.

Supervision

In 1985 the Jordan Central Bank declared a law called the Jordan Islamic Bank for Finance and Investment Law of 1985 which determined the way the JIB

could operate.¹ In this document the central bank recognized Islamic banking as a new movement in Jordan and, believing that it needed a special law, issued this one. The law tries to cover the most important issues and expresses them in a detailed way intended to help the Islamic banking movement. But, as mentioned, Jordan still has only one Islamic bank. At present, the Jordanian authorities do not contemplate issuing a licence to establish another one,² and the monetary authority does not, so far, allow the conventional banks in Jordan to open an Islamic banking counter.³ The conventional banks have complained formally to the central bank about this. The complaint was lodged after a major account was shifted from one of the conventional banks to the JIB (Liwa, 1980). Shallah (1990) states that the JIB is constrained by the central bank's regulations including the prescribed reserve requirements, liquidity ratios and other factors related to credit control in the country. It is worth mentioning also that the JIB is deprived of a number of facilities given to other banks; for example, it does not benefit from support provided by the central bank as the lender of last resort to banks which experience a need for prompt liquidity, and it is also deprived of facilities, given to conventional banks, to encourage exports at a discounted rate.

Wilson (nd) believes that the Central Bank of Jordan has responded positively to the establishment of Islamic banks in Jordan and recognized that many Muslims were unhappy with the kind of banking facilities offered by the *ribā* commercial banks. This position was supported by the governor of the central bank. He stated in an interview that the central bank is giving its full support to the Islamic banking movement and he believes that the JIB fills a gap which none of the conventional banks in Jordan can fill. The head of the research department in the Central Bank of Jordan, asked about what sort of support the bank could offer the JIB, had this to say:

By establishing a special law to organize its operations, which means that we recognize such a movement and we do not allow conventional banks to practise Islamic banking operations, thus protecting JIB from competition from conventional banking.

Business relationship with other financial institutions

Unlike Al-Baraka International Bank in London, JIB has an extensive and relatively large branch network spread all over the kingdom. It has not therefore established any bilateral agreement with the Jordanian conventional banks to manage its short-term funds. As indicated earlier, the conventional banks in Jordan consider JIB to be a threat and are trying to put pressure on the monetary authority to allow them to open an Islamic counter within their banks. But so far, as mentioned earlier, the central bank has refused. Apart from that, the relationship between the Jordan Islamic banks and the other conventional banks does not go beyond clearing each other's cheques.

Fund collection

The types of account available at JIB are as follows:

Trust accounts

Cash deposits received by the bank are not subject to any conditions for withdrawal or deposit. In other words, the bank permits deposit and withdrawal at any time without any conditions or restrictions and processes the payment and collection of cheques and money orders on behalf of clients as there are no conditions to these deposits. The bank has the right to use these deposits at its own risk and to take responsibility in respect of profit or loss.

Joint investment accounts

These include cash deposits received by the bank from persons wishing to participate with the bank in multilateral and continuous investment and financing operations, whereby such deposits receive a certain percentage of the annual net profits realized, in accordance with the conditions of the account under which they are entered. They include (Shallah, 1990):

- **Fixed-term or time deposit.** The minimum amount required to open a time-deposit account is JD (Jordanian dinar) 500 in local currency and JD1,000 if the deposit is in a foreign currency. This money must be deposited for a period of at least one year, and share in profits is payable in the month following the date of the deposit. Return on investment is determined according to the results of investment operations and the amount and period of the deposit. Time deposits earn the highest return: 90 per cent on the declared profit.
- **Deposits subject-to-notice.** The minimum amount required to open a notice-deposit account is similar to that of the time-deposit account mentioned above. These deposits differ from time deposits in that depositors are not allowed to withdraw any of their funds without 90 days advance notice in writing. The share in profits is about 20 per cent for the bank and 80 per cent for the client of the profit declared by the management.
- **Saving accounts.** In these deposits the client can withdraw and deposit at any time and can deposit any amount according to the conditions specified by the bank. The minimum balance that is required for investment and for a share in profits is set at JD100. Saving deposit account holders participate in profits realized from investments at the rate of 50 per cent of the declared profit.
- **Specific investment account.** Cash deposits are received by the bank from persons desiring to appoint the bank as an agent for investment of these deposits in a specific project or in a specific manner, on the basis that the

bank will receive a part of the net profits realized, but without liability for any losses not attributable to any violation or default by the bank.

Other banking services

These include:

- Accepting cash deposits;
- current and deposit accounts of various types which the bank pays and clears clients' cheques, collects bills of exchange, transfers funds within or outside the kingdom, opens documentary credits and gives notification thereof, and issues bank guarantees, personal letters of credit and cash-point cards;
- dealing in the purchase and sale of foreign currencies on the basis of spot rates only. (JIB is permitted to undertake mutual lending in various currencies without interest, as may be required);
- giving fixed-term loans as a service without interest, either by discounting commercial short-term promissory notes or by instalment lending (the bank may not offer this service, under any circumstances, on the basis of an overdraft current account);
- management of properties and other assets which can be managed by the bank on the basis of an agency fee;
- acting as an appointed trustee, in accordance with the *Shari'ah* and the laws in force in the kingdom, in cooperation with a recognized religious body; and
- special studies on behalf of clients and the provision of information and consultancy services on various matters.

Functions

As stated in Chapter 2 of the Jordan Islamic Bank for Finance and Investment Law, the functions of the bank are to provide:

- **Non-usurious banking operations:** such as accepting deposits, opening documentary credits, personal letters of credit.
- **Social services:** the JIB is to act as a trustee in organizing social services designed to strengthen the ties of solidarity and co-operation among various groups and individuals, through the following activities: (a) giving beneficial loans for productive purposes in various fields in order to enable the beneficiaries to start independent lives or to raise their incomes and standards of living; (b) establishment and administration of special funds for various worthy social purposes; and (c) any other activities within the scope of these general objectives.
- **Financing and investment activities:** the bank is to carry out non-usurious financing and investment operations by the following means: (a) providing

the necessary financing, fully or partially, in the various cases and undertakings which have a self-supporting potentiality, including the various forms of *mudārabah* financing, participation, and purchasing for others on a pre-agreed profit basis; (b) investment of funds, the owners of which desire to invest them jointly with the other resources available to the bank on a joint *mudārabah* basis. In particular cases the bank may invest the funds in some other specified manner by special agreement.

The general manager and other managers in the bank were asked: What are the functions and role of your bank? Do you see your bank as a profit-seeking institution or as a social-development institution? The answers varied. Some respondents believed that Islamic banks are entirely profit-seeking institutions and that, apart from the interest rate, there is no difference between them and conventional intermediary banks. Others believed that after profit an Islamic bank's second aim should be the development of the community in which the bank exists. Others believed that Islamic banks cannot be profit-seeking institutions because of their nature and because Islamic law prevents them from using the available market instruments, most of which depend on interest. Islamic banks are developmental banks by nature. When those who took this view were asked whether there is anything the JIB does that other conventional banks do not do, they answered affirmatively:

We offer our clients *zakāh* services; we distribute *zakāh* on their behalf if they wish; we have a *qard ḥasan* fund to help people facing serious problems, especially for medical treatment, for study and for marriages; we are trying hard to implement PLS as long as the interest of the bank is not jeopardized; and lastly and most importantly, we finally succeeded in overcoming the dilemma which a lot of Muslim societies have had, which was how to bank and invest money in the banking system without violating Islamic law.

When the authors asked ten clients of the JIB what they thought the characteristics of an Islamic bank should be, all of them put working under Islamic law as the first priority; some put making profit as the second, and responsibility towards Jordanian society as the third. When asked whether profit was a motivating factor, they said it was not. Their reasons for banking with JIB were, first, that it offered Islamic transactions and, second, that it offered a secure place to put our money.

The Bank's Transactions and Conformity to Islamic Values

Section 6 (Chapter 8) of the Jordan Islamic Bank for Finance and Investment Law of 1985 states explicitly that the bank aims to meet economic and social needs in the field of banking services and financing and investment operations on a non-usurious basis. Non-usurious banking operations have been defined on the first page of the 1985 law as any activities which the bank is able to

carry out in the field of banking services, financing and investment, applying such methods as are in compliance with the principles of Muslim *Shari'ah* law.

Section 27 (Chapter 8) of the 1985 law, entitled 'Legal Consultant on Islamic Law', deals with the selection of a specialist in the practice of Islamic law, who is to be appointed as an Islamic legal consultant, and who can be dismissed only with the consent of at least a two-thirds majority of the board of directors. Section 28 (Chapter 8) requires the board of directors to determine the functions of the Islamic legal consultant on the basis that the board shall request the opinion of the Islamic legal consultant regarding: (i) the practical regulations and rules applied by the bank in its dealing with others, with a view to ensuring that they do not contain any form of usurious dealings which the bank is obligated to avoid; and (ii) studying the causes which require the bank to bear any investment loss, with a view to finding the legal doctrinal (*fiqhi*) basis to support the resolution of the board in this regard.

So the board of directors of JIB appoint their *Shari'ah* consultant whose remit is to study the bank's instructions and operations in all its various deals and transactions and ensure that they do not, either implicitly or explicitly, have any sort of illegal aspect, from an Islamic point of view.

Shallah (1990) states that, . . . according to the bank's law, the board of directors is entitled to appoint and dismiss the *Shari'ah* adviser. His remuneration is also to be fixed by the board of directors. Thus such status for the *Shari'ah* adviser has been criticized by many Muslim scholars since it may threaten his independence to give the correct judgement without undermining his own position.

The JIB board of directors did appoint a respected *Shari'ah* committee. It appears that JIB's motive for doing so was only to seek proper criticism from professional scholars. On more than one occasion the *Shari'ah* committee forced the board to review some of its decisions because they were not Islamically acceptable. In the *Shari'ah* committee's opinion a booklet should be prepared and made available to clients (and others), informing them of the details of *Shari'ah* provisions regarding the bank's operations.

Regarding ethical banking, three executives of JIB were asked how far Islamic values shape strategic goals and whether they can be translated into institutional forms that operate Islamically, and whether or not Islamic transactions or investments can still be profitable from an economic point of view. The unanimous answer was that they will never accept any deals which could violate Islamic law, either explicitly or implicitly. Regarding whether the Islamic transactions can still be profitable from an economic point of view, the answer was affirmative. While some of the interviewees expressed the view that it could be more difficult, the JIB general manager

said that what actually makes his bank a profitable one is its being an Islamic bank.

Two managers in the JIB were asked in interviews what criteria they applied when deciding whether or not to get involved in any new business. The answer given was that they ensure that the project being assessed does not contradict Islamic norms and values, and that if any transaction did or might do so, they would not enter into it under any circumstances.

Shallah (1990) suggested two questions which are relevant here before judging how far the JIB accepts social responsibility among its objectives: how successful is the bank in mobilizing financial resources (attracting deposits)? and are these resources deployed successfully to promote socio-economic development?

The JIB (since 1987) ranks third amongst Jordanian banks in terms of deposit growth; since then it has also become the third in terms of deposit size. In other words the JIB has overtaken some leading banks, such as the Jordan National Bank and the Bank of Jordan, which implies that the confidence of the community in the JIB is growing; these developments do not necessarily mean, as Shallah concluded, that there is increasing confidence in Islamic business, or that the Muslims in Jordan are becoming more devoted to Islam.

The social impact of the JIB's policies is related primarily to two areas of its activities. The first is interest-free loans. These are the only kind of transactions in which an Islamic bank can give a cash loan to its clients while not expecting any profit or charging commission. Such loans are made out of an idea of social responsibility and not for any other reason. The JIB has determined that interest-free loans should be made only in cases of personal need, such as marriage, education or medical treatment. The bank lends the maximum amount of JD500 (approximately £500), repayable within 12 months.

In more recent years, the bank has established a new, interest-free loan fund to hold the deposits of people who want to give to the needy. By the end of 1991 there were JD38,000 in this account. The total value of interest-free loans given by the bank (including those from this fund) was JD1.13 million, from which 3,131 people benefited. In 1990 the total was JD1.1 million and the number of beneficiaries was 2,664. It could be concluded from the above record that the JIB is trying to practise its social responsibility through giving these interest-free loans, and is aware that these loans should be increased to relieve the people of hardship (JIB, 1991).

The second area of social impact by the bank is the financing of the purchase of equipment and furniture by educational institutions such as universities and colleges. JIB is keen to participate in such activity and to do so on a profit margin not exceeding 2 per cent.⁴

Fund utilization

The JIB, as stipulated in the 1985 law, carries out non-usurious financing and investment operations. In practice, the bank depends mostly on *murābahah* transactions of a certain pattern, such as the financing of building materials, the purchase of cars, durable goods, and the purchase of equipment by professional people such as doctors. The *murābahah* transactions of the JIB proceed as follows. If a client decides to buy a car, he goes to the JIB and asks it to provide him with this car. Before anything else, the bank makes sure that the client is able to repay the money. When it is confident on this point, it asks the client to choose the car which is available in the market which he would like to have, within a certain monetary limit. Let us suppose that the client finds a car which costs JD10,000 and that figure is within the limit. He asks the bank to provide him with the car. The bank sends a representative to buy the car under a binding agreement so that the client cannot change his mind about the purchase of the car. When the bank has registered the car in its name, it sells it immediately to the client at JD10,000 plus profit; usually this profit is equal to the price of interest, or more, for the repayment period. After that the client starts to pay back the amount in monthly instalments. The theory of Islamic banking justifies the profit from the mark-up for the services that the finance owner provides, namely seeking out, locating and purchasing the required goods at the best price (Khan, 1988). It is worth mentioning here that the client owes the bank a fixed amount of money which cannot be exceeded. The JIB's policy is to take more profit on luxury commodities than on productive and necessary commodities. The evidence suggests also that it is very rare for the bank to accept any deal which depends upon PLS for the reasons which we have explained in Chapter 3. As the investment manager of the JIB said during an interview: 'We now work mostly on *murābahah* because we like to concentrate on safe investments'. This is supported by what Shallah (1990) concluded in his comment about the bank's investment policy of emphasizing short-term trade finance: 'It seems that the bank has adopted a risk-taking' policy'. In answer to this criticism which points to a discrepancy between ideology and practice, JIB's general manager said that this is not a consequence either of ignorance or of a lack of commitment on the bank's part, nor of a lack of social responsibility. Rather, it is the hostile and discouraging environment, indicated earlier, with all its implications that makes it very risky for the bank to invest its funds in medium and long-term projects. The difficulty of identifying responsible entrepreneurs with the required guarantee for conducting long-term business is only one example of this. When the JIB investment manager was asked how PLS can be revived, he replied that it might be possible if: (i) reputable clients were chosen; and (ii) guarantees taken. To assess a particular potential client as being reputable or not, he would find and study that individual's record.

Performance

Management

The main bodies which manage and supervise the JIB are the board of directors and the general assembly. Their characteristics are similar to those of any conventional bank. The evidence from our study tends to suggest that the management, represented by the general manager of the JIB, is responsible for the bank's success. In an interview, he named the most important goals for the institution as: developing the bank's image; satisfying clients' needs by increasing the range of services available; increasing the bank's market share; and maximizing profitability.

The JIB recruited some of its senior staff from other, conventional Jordanian banks. During the course of our study, we discovered that, despite the fact that management has begun to give some attention to training its employees, there was a serious lack of a proper training programme particularly at the middle management levels. It is important that the management of the bank, aware of the lack of training, be prepared to institute intensive training programmes for middle management.

In another interview, the general manager set out the major obstacles which face the bank:

- The JIB has found itself forced, in order to make up the disadvantage of not being able to use the central bank as lender of last resort, to make most of its financing operations short or medium term, and to hold high levels of cash in notes in case of emergencies.
- Lack of enough financial instruments like bonds; for example, if the JIB could hold listed securities issued by high-quality corporations, this could be a substitute for cash.
- There is a lack of knowledge on the part of clients about Islamic banking instruments. Thus, when the JIB asks its clients for a percentage of profit on *murābahah* transactions, some clients jump to the conclusion that this is a disguised interest-rate transaction. In other words, some clients who thought that the JIB was a charity were disappointed when they discovered the reality of the situation (that the JIB does not do something for nothing).
- The JIB has also found itself forced to take a tougher line on guarantees when it agrees to finance any project. The reason for this is that in the past some clients have tried to take advantage of the fact that the JIB is not able to charge interest on late payments of bills as conventional banks can. There is no penalty for late payment under Islamic law.
- There is a lack of well-trained and qualified staff employed in Islamic banks.

The general manager put the JIB's success down to: not contradicting *Shari'ah*, increase of client deposits; increasing investments made for clients;

giving an acceptable rate of return to shareholders, depositors and investment clients; promoting understanding among management and employees of the nature of the Islamic values related to financial techniques; and maintaining a good relationship between the institution and the society in which it operates.

When five managers of the JIB were asked whether their bank's transactions took more time or cost more, two answered that they didn't, that in their own experience there was no difference at all. The others could not give a clear answer, but one of them suggested that a difference would probably be found if the JIB is compared with other international banks, though not with other Jordanian banks.

Marketing and client services

The JIB does not have a 'marketing' department. When asked why not, employees answered that: 'Islam is the best Marketing Department for us'. From this we can infer that Islamic transactions are welcomed in Jordanian society. Wilson (nd) comments that the JIB seems to have attracted several thousand customers who had not previously been in the banking habit. In the JIB, marketing is the responsibility of the general manager and the public relations manager, which means that marketing policy is directed mainly from the Head Office.

The JIB has some 273,000 depositors in 29 branches all over Jordan, that is, it has a large network of depositors whose needs have to be met. JIB recently started to computerize its procedures and transactions, but to date it does not have an ATM (automated teller machine) service.

Interviews with ten JIB clients tried to establish the main reasons for their banking with the JIB. All of them said they deposited their money in the JIB because it is an Islamic bank; four out of ten clients had opened their first bank account with the bank, which supports one of Wilson's (nd) observations; seven out of ten did not have any other account in any other bank in Jordan; some of them expressed their dissatisfaction in that JIB takes marginal profit and costs them more than would a conventional bank and paying of interest; as to the question whether, in their opinion, the JIB really was working under Islamic law, some answered positively, while others equivocated, saying 'Even if it does not, Allah will punish them. We trust them to make *halal* profit and this is what they say that they will give us. But if they do something else it is they who will be punished by Allah, not us, because we have the good intentions to work within *Shari'ah*.

Financial performance

The JIB is now considered to be one of the largest financial institutions in the kingdom as well as one of the most successful Islamic commercial banks at the retail level (Presley and Wilson, 1991).

Table 4.1: *Profile of the Housing Bank's financial performance (Jordanian dinar)*

	Capital	Assets	Capital assets (%)	Pre-tax profits	Return on capital (%)	Return on assets (%)
1988	27,667,958	518,174,505	5.33	3,158,043	11.41	0.60
1989	29,565,634	561,484,005	5.26	3,418,622	11.56	0.60
1990	31,242,783	607,239,077	5.14	3,671,492	11.75	0.60
1991	33,008,383	824,341,682	4.00	3,805,996	11.53	0.46

Source: The Housing Bank's annual reports and accounts, 1989 1990, 1991.

The following analysis will include a comparison between the JIB and the Housing Bank. The Housing Bank is a suitable case for comparison. It is not as the name implies involved purely in residential real-estate lending but acts as the second-largest commercial bank in Jordan, in terms of assets and deposits. The comparison will examine return on capital and return on assets for the period 1988-91.

It may be seen from Tables 4.1 and 4.2 that, in terms of return on capital, the JIB achieved better results than the Housing Bank. Since 1989 JIB's return on capital for the years 1989, 1990 and 1991 was more than double that of the Housing Bank. In terms of the return on assets we find that again the JIB achieved better results throughout the entire period 1988-91.

As shown in Table 4.3 the revenue for the depositors is less than for the shareholders, so the profit distribution is in favour of the shareholders. Shallah (1990) comments on this: '... since the funds of both shareholders and depositors are employed in the same uses facing the same level of risk, such an unbalanced distribution of profits between them can be criticized as unfair'. However, Shallah forgets that the shareholders' responsibility is much greater than the depositors'. While the risk to the depositors' money does not extend beyond their individual deposits, the shareholders' responsibility does extend beyond their individual share to the whole bank.

Table 4.4 shows that the share of *murābahah* decreased only by 1.73 per

Table 4.2: *Profile of the JIB's financial performance (Jordanian dinar)*

	Capital	Assets	Capital assets (%)	Pre-tax profits	Return on capital (%)	Return on assets (%)
1986	9,791,314	161,661,533	6.05	949,466	0.64	0.58
1987	9,935,404	197,416,645	5.03	1,021,081	10.27	0.51
1988	10,260,764	222,584,341	4.60	1,338,403	13.04	0.60
1989	10,694,867	242,323,408	4.41	3,063,883	28.64	1.26
1990	11,947,200	244,830,709	4.87	3,182,329	26.63	1.29
1991	12,819,785	356,751,185	3.59	3,207,585	25.02	0.89

Source: The JIB annual reports and accounts, 1986-87, 1988, 1989, 1990 and 1991.

Table 4.3: *Development of the JIB's performance over ten years (1982-91) (Jordanian dinar)*

Year	Total assets	Cash in the bank & other banks	Total deposit	Total investments & finance	Investment revenue before	Capital paid & retained	Risk-investment account	Revenue for the depositors %	Revenue for the shareholders %
1982	45,238,025	12,800,393	35,833,977	26,471,772	2,516,900	4,219,913	860,778	7.20	8
1983	71,483,978	25,437,099	58,565,849	37,591,249	3,073,133	4,359,283	1,475,404	5.40	8
1984	102,092,176	27,555,017	82,868,746	63,013,403	4,655,399	4,627,243	2,406,484	5.70	9
1985	126,774,045	38,855,419	102,864,396	71,013,906	5,411,864	4,891,711	2,817,358	5.48	9
1986	161,661,533	45,766,074	127,613,952	95,461,377	6,466,580	9,791,314	2,685,601	5.10	9
1987	197,416,645	65,956,075	158,503,660	108,997,214	7,721,584	9,935,404	3,416,197	5.05	9
1988	222,584,341	74,764,664	177,803,749	124,149,759	9,624,790	10,260,764	4,097,477	5.35	12
1989	242,323,408	70,037,877	187,242,091	144,078,171	13,715,673	10,694,867	5,161,520	7.25	10
1990	244,830,709	70,870,684	190,382,382	148,878,109	16,269,904	11,947,200	6,219,399	7.85	12
1991	356,751,185	135,195,264	296,976,591	193,091,736	19,309,632	12,819,785	7,473,342	7.84	12

Source: The 1991 JIB Annual Report.

Table 4.4: *Distribution of transactions by the JIB (Jordanian dinar)*

Year	PLS and Others	<i>Murābahah</i>	Total	<i>Murābahah</i> % to Total
1984	11,764	51,249	63,013	81.33
1985	14,882	56,132	71,014	79.04
1986	19,464	75,998	95,462	79.60

Source: 'The Experience of the Jordan Islamic Bank', a published lecture given by Musa Shehadah the General Manager.

cent between 1984 and 1986. However, the investment manager pointed out in discussion that in 1992 more than 95 per cent of the JIB's transactions depended on *murābahah* financing with *murābahah* and *mushārahah* representing less than 1 per cent of the total. This means that short-term trade financing was overwhelmingly the most popular transaction amongst the financial operations of the JIB and that therefore the share of PLS had fallen from 19.67 per cent in 1984 to 1 per cent in 1992.

In comparing the 1991 results with those of 1987 in terms of sectoral distribution of the bank's investment, Table 4.5 shows that the JIB was keen to distribute its investments over different sectors and activities, a policy confirmed in an interview with the investment manager.

Shallah (1990) considers the major weakness of the bank's financing policies as the shortfall in its advances to the agricultural sector (0.6 per cent in 1987), a sector which has been almost entirely neglected. He concludes that this is evidence that the JIB has taken no role in assisting farmers with funds and means of production. But Shallah ignored the fact that the bank is answerable to both shareholders and depositors and must show profitable returns on the money they have entrusted to it, combined with the fact that the agricultural sector in Jordan has always suffered from very low rates of return

Table 4.5: *Distribution of assets by the JIB (Jordanian dinar)*

Year	Industry	Trade	Property	Small businesses	Transactions	Others
1987	35,940	25,749	17,69626	12,695	5,739	12,492
%	32.9	23.6	16.2	11.6	5.2	10.5
1988	32,334	34,822	16,711	19,849	5,895	14,993
%	26	28	13.4	15.9	4.7	12
1989	46,141	32,191	21,765	23,818	5,120	15,580
%	31.9	22.3	15	16.5	3.5	10.8
1990	32,916	35,709	22,514	33,728	5,873	18,138
%	22.1	24	15	22.7	3.9	12.2
1991	41,744	50,236	20,956	52,415	4,848	22,842
%	21.6	26	10.9	27.2	27.2	11.8

(Abdel-Haq, 1989). The reasons behind the bank's financing policies become understandable in an economic if not necessarily a social, context.

Notes

1. Chapter 1 comprised definitions and general provisions; Chapter 2 the objectives and functions of the bank; Chapter 3 specified the minimum capital base; Chapter 4 allows for acceptance of deposits and issue of *al-muqaradah* bonds; Chapter 5 lists the rules governing the activities of the bank; Chapter 6 defines procedures of management of the bank and general meetings; Chapter 9 states requirements for final accounts, balance sheet and profit-and-loss accounts; Chapter 10 explains the bank's liability to income tax.

2. Information from the general manager of JIB, personal interview.
3. Information from the governor of the Central Bank of Jordan, personal interview.
4. An interview with the general manager.

CHAPTER 5

Special Finance Houses in Turkey, with Emphasis on Al-Baraka Turkish Finance House (Al-Baraka Turk)

This chapter examines the phenomenon of Islamic (interest-free) banking in the context of the secular financial system in Turkey. It also discusses the establishment, objectives, supervision, functions, and the performance of Al-Baraka Turkish Special Finance House and the extent to which Islamic values determine its priorities and fund utilization.

At the time of Turkey's most recent census, conducted in 1990, the country's population was nearly 57 million (Aksit, 1992). The great majority of Turkish citizens are Muslims and they respond positively to the phenomenon of interest-free banking and give the special finance houses (SFHs) encouragement to strengthen their presence and position in Turkey.

Despite the successes of the special finance houses in the Turkish financial markets the evidence leads to the view that Islamic banking in Turkey in the foreseeable future will remain a minority subsector.

Legal framework

What is legally named the 'special finance house' is a recent phenomenon in the Turkish financial sector. Entering the Turkish financial system some ten years ago, this type of Islamic bank has, however, shown rapid growth because it has managed to attract a sizeable number of clients, with its market share in the Turkish financial system measured by a balance-sheet size which has reached around 1 per cent. It is essential to bear in mind the fact that the finance houses operate in a highly inflationary environment which has existed for the past fifteen years.

The rationale behind the emergence of Islamic financial institutions in Turkey is summarized in Buyukdeniz (1991):

The development of money and capital markets in developing countries is impeded by a number of factors, including underdevelopment of financial institutions, limited availability of asset choices for savers, economic instability, lack of education and information and the like. The problem becomes even more acute in countries with a predominantly Muslim population who for religious reasons prefer to abstain from being associated with the conventional banking system based on interest. As a result there occurs a leakage of savings from the financial system and savings are often placed in unproductive investments. Under these circumstances, financial

institutions based on interest-free principles have emerged in order to introduce such funds into the national economy. This is, however, not to undermine the significance of a profit motive alongside moral and ethical factors in the process of shifting funds into Islamic banks. Perhaps the most important effect of these institutions has been on saving habits.

There is also a case for arguing that equally relevant for the inception of Islamic banking in Turkey was the fact that three of the large Gulf-based Islamic banks saw a market opportunity which they wished to exploit with the help of local Turkish shareholders.

A profile

The establishment and function of SFHs are regulated in detail by the government. Whilst SFHs are not subject to the prevailing Banking Act in the country, like the commercial banks they are supervised by and subordinated to the Treasury Undersecretariat and the Central Bank.

SFHs are authorized to collect deposit funds from the public, within Turkey and from abroad, under special current accounts and profit-and-loss participation accounts. SFHs are required to deposit 10 per cent of participation deposits and 20 per cent of current deposits with the central bank as reserve requirement. They also hold full exchange licences which enable them to carry out all sorts of foreign currency transactions permissible under the prevailing foreign-exchange and foreign-trade regimes. They are required to report regularly to the central bank on their foreign-currency position (on a weekly basis) and observe certain ratios on a weekly basis (foreign-currency risk ratio and foreign-currency liquidity ratio).

In this respect SFHs do not differ in any way from commercial banks in the country. In so far as their tax status is concerned, profit incomes on Turkish-lira (TL) and foreign-currency participation deposit accounts are subject to a 10.6 per cent withholding tax and funds. Commercial banks, on the other hand, are in a more privileged position as interest-income earned on commercial banks' Turkish lira time-deposits is subject to a 5.3 per cent withholding tax and funds (taxation on foreign-currency time-deposits is similar to the SFHs' 10.6 per cent). On the other hand, SFHs, established in the form of a corporation like commercial banks, are subject to the prevailing corporate tax on their company profits.

There are four special finance houses in Turkey: Al-Baraka Turkish Finance House (Al-Baraka Turk), the Faisal Finance Institution, the Kuwait Turkish Evkaf Finance House and the recently opened Anatolian Finance House. (The total number of SFH branches had reached 45 by the end of December 1994.) The first three institutions are Turkish – Saudi or Kuwaiti joint ventures, while the Anatolian Finance House is 100 per cent controlled by local shareholders. In accordance with the relevant decrees and regulations governing the establishment, organization and functioning of SFHs, the SFHs are not

regarded as conventional banks and are subject to different rules. (The term 'special finance house' is used as an alternative to Islamic bank because the Turkish constitution does not allow any institution to call itself Islamic or to have Islam as a policy objective.) There are consequential differences in the role of SFHs as regards fund collection and fund utilization as we will see later.

Supervision

The monetary authority in Turkey does not recognize anything called Islamic banks for constitutional reasons. However, as mentioned above, it instituted a decree which set out the methods and procedures for the establishment of SFHs. The decree contains seventeen articles, of which, in our opinion, the most important are:

- The central bank fixes the reserve and liquidity ratios which differ from those of the *ribā* commercial banks which have recently been changed. Accordingly, the reserve ratio on current accounts is 16 per cent and on participation accounts, 8 per cent. Liquidity ratios on current accounts are 10 per cent.
- The central bank is responsible for auditing the accounts and supervising the operations of the SFHs.
- Permission from the authorities is required for each new branch. To open a branch a minimum capital of TL5 billion is required, as against TL1 billion for conventional banks.
- The monetary authorities in Turkey do not allow the SFHs to mention the word *Shari'ah* or Islam in any of their advertisements or transactions; nor are the SFHs allowed to appoint a *Shari'ah* consultant or religious adviser.

Fund utilization

Trade financing

Financing is provided to individuals or companies applying to purchase real estate, raw and semi-processed materials, machinery and equipment. This form of purchasing in cash from third parties and selling on a deferred-term basis (*murābahah*) accounts for more than 90 per cent of the SFHs' total fund utilization. It is worth asking whether under this type, for example, of financing the buyer expects the bank to find the property for him. Clearly this is not the case. Khan (1988), as mentioned before, justifies the profit which emerges from *murābahah* contracts as follows:

However in theory the mark-up is not in fact in the nature of compensation for time or deferred payment, though the entire cost had to be incurred because the needy person did not have means at hand to make the purchase he wanted. The

mark-up is for the services that the finance-owner provides, namely, seeking out and locating and purchasing the required goods at the best price.

But in practice the bank offers only to pay, while the clients usually do all of the work, such as locating and purchasing the required goods at the best price; the client then pays back the money under instalment agreements, which is the capital plus the profit, which is usually equal, more or less, to the interest price.

Project financing (PLS)

Participation in profits and losses may be in the form of full participation in all the profits and losses arising from all of the activities of fund utilization in the form of participation in the profits or losses arising from a particular activity or from the purchase and resale of a particular lot of goods. Al-Baraka Turk participates in the profits of individuals or legal parties to whom it has made funds available in the ratio specified in the contract.

Leasing

Special finance houses and leasing companies in Turkey are subject to the prevailing Financial Leasing Act (June 1985) by which they are authorized to undertake financial leasing (full pay-out leasing) transactions, where the sale price at the end of the lease contract is determined at the outset. In 1987 Al-Baraka Turk started to finance medium-term projects by means of leasing. The projects involved the leasing of items such as textile machinery, machines, buses, cars and planes, with repayments scheduled over a four-year period. At the end of the leasing period the client makes a final repayment and obtains ownership of the goods in question. To be acceptable Islamically, leasing contracts must meet certain conditions (see Chapter 1), but especially important here, as Naseef (1988) identified, is that the price of an asset that may be sold to the lessee at the expiry of the contract cannot be pre-determined. It can be determined only at the time of the expiry of the contract.

Ninety per cent of Al-Baraka Turk's investments depend heavily on *murābahah* transactions, leasing accounts form about 7-8 per cent, with the remainder made up of different sorts of transactions (without interest and not PLS). It was mentioned by a manager that, to date, Al-Baraka Turk is believed not to have set up any PLS transactions.

In answer to the question why Al-Baraka Turk has not made use of PLS, two board members and the general manager believed this was because SFHs in Turkey are new: 'In consequence, the SFHs have to protect their interests and their depositors' money'. Therefore, PLS, being thought too risky, was not a viable option. The bank decided that in the early stages it should seek to be profitable within Islamic law, regardless of the type of contract used, and the bank has indeed succeeded in protecting depositors' and shareholders' interests and turning out a profit. At the next stage of development, the bank

claims that it will consider giving more weight to PLS-type contracts. The interviewees pointed out that, to implement PLS, the clients would have to change their attitude, that is, to be more honest. The broad intention of the bank's strategy is: 'We will implement it [PLS] gradually: 90 per cent of our contracts are *murābahah* and 7-8 per cent leasing'.

Profit-and-loss distribution to SFH participation accounts

The method of profit-and-loss distribution to SFH participation accounts is determined by the government. Accordingly, SFHs in Turkey are permitted to conduct profit-and-loss distribution to participation accounts on a daily or weekly basis. The existing SFHs adopt weekly profit-and-loss distribution on an accrual basis for its practical advantages, and announce the resulting weekly unit value (UV) for each pool at regular intervals in various newspapers.

Unit value is a sort of share-price index reflecting profit/loss developments in a given pool of participation deposits. It involves a week-by-week comparison of the total asset value (net worth) of a given pool, and changes as profit-or-loss is recorded to the pool. Weekly calculation and announcement of UV allows participation account holders conveniently to follow up the performance of the pool in which they have invested. By multiplying the weekly announced UV by the account value (a coefficient indicating the relative participation share of an individual account in a given pool of participation funds, written on the participation account certificate), an account holder is easily able to know the outstanding value of his participation account.

The profit-and-loss participation deposit funds managed by SFHs are in the nature of an open-ended mutual fund. SFHs calculate and announce on a weekly basis a UV for each investment pool, which enables depositors conveniently to follow up the outstanding value of their investment (participation) account. This feature of participation accounts has the potential of making participation account certificates a future capital-market instrument together with the creation of a secondary market in which these certificates are actively traded.

Financial performance of SFHs within the Turkish financial system

The Turkish financial system is dominated mainly by commercial banking, with around 70 per cent of the total funds in the economy going through the commercial banks. Commercial banks have a long tradition in the country, and as of December 1994 the total number of banks stood at 67, with 6,157 branches throughout the country. There is a high market concentration in the banking system, the top ten banks (half of which are public banks) controlling around 75-80 per cent of total deposits and also of credits. With respect to the size of the balance sheet, as of the end of December 1993 banks ranked

Table 5.1: *Relative importance of various institutions in the Turkish financial system*¹ (by balance-sheet size)

	Percentage share				
	1993	1992	1991	1990	1989
The central bank	16.61	20.15	20.98	23.25	28.45
Banks	58.79	57.53	60.06	59.66	57.35
b.1) commercial banks	54.52	53.19	54.79	54.30	51.92
b.2) investment and dev. banks	4.27	4.37	5.27	5.35	5.43
SFHs	0.97	0.85	0.75	0.62	0.51
Insurance companies	1.06	0.97	0.99	0.92	0.68
Financial leasing companies	1.15	0.80	0.69	0.64	0.26
Stock Exchange	21.42	19.70	16.52	14.91	12.75
Total	100.00	100.00	100.00	100.00	100.00

Note: 1. The total balance sheet size of the Turkish financial system had reached TL 1,747,191 billion (equivalent to US \$204.2 billion) by the end of 1993.

first in the Turkish financial system (around 59 per cent), followed by the Stock Exchange (21.42 per cent) and the central bank (16.61 per cent). Whilst the share of SFHs has shown a steady growth over the years, their share is still around 1 per cent.

After examining the relative importance of various financial instruments in the Turkish financial system, it is seen that bank deposits take up a share of around 50 per cent, followed by government debt instruments (27.68 per cent), due to the government's heavy reliance on domestic borrowing. The share of private-sector financial instruments (shares, bonds and commercial papers) is around 12 per cent.

The share of SFH participation and current accounts has shown a steady growth over the years, rising from 0.76 per cent of the total financial instrument in 1989 to around 1.54 per cent in 1993, while the share of SFH participation and current accounts as a percentage of commercial-bank deposits has risen from 1.27 per cent in 1990 to around 2.75 per cent in 1993.

It is believed that the share of SFHs in the national financial system is potentially much higher than its present level, and should rise substantially parallel to the increase in the number of SFH branches throughout the country and under a more stable financial environment (lower inflation rates, stability in financial rates and higher competition in the financial markets).

Given the short history of the existence of SFHs in the Turkish financial system, as compared to the longer history of the commercial banks, and their relatively limited branch network throughout the country, the SFHs' existing share indicates the steady growth of these institutions since their establishment.

Table 5.5a shows the SFHs' growth in deposit market-share. In 1985 the SFH share of deposits collected stood at 0.36 per cent; by 1991 it had grown

Table 5.2: Rates of return on SFH participation accounts and commercial-bank deposit accounts compared (per TL100,000)

1994 ¹	SFH participation accounts ²	Commercial-bank deposit accounts ³
One-month	4,157	3,937
Three-months	14,480	14,848
Six-months	29,897	31,570
One-year	66,911	91,270

Notes: 1. As of 28 October 1994.

2. Net rate of return (after deducting 10.6 per cent withholding tax and fund); weighted average of four SFHs.

3. Net rate of return (after deducting 5.3 per cent withholding tax and fund); weighted average of commercial banks.

to 2.82 per cent. This development becomes clearer if we link it with Table 5.5b, which shows the number of branches of SFHs against conventional banks in 1991. While the conventional banks had 6,727 branches and TL 92,026,000 million in deposits, the SFHs had 21 branches and TL2,593,959 million in deposits. If the SFHs in the 1991 deposit base were in line with the number of their branches, they should have accepted only TL287,281 million in deposits, whereas in fact they accepted about nine times more than that.

Table 5.6 shows the improvement in the SFHs' market-share *vis-à-vis* the conventional banks' credits (the SFHs' relative growth in investment as set). The figures in both tables 5.5a and 5.6 suggest that SFHs are strong, and have made impressive increases in their deposits market-share and funds utilized: within the seven years 1985 to 1991, the former had jumped from 0.36 per cent to 2.82 per cent, the latter from 0.48 per cent to 3.30 per cent. The growth is all the more striking in view of the number of branches conventional banks have (6,727 in 1991) as against the number for the special finance houses (21).

Table 5.7 compares the rate of interest paid since 1985 by conventional banks, and the rate of return of the profit share paid by the SFHs. Profits shared since 1985, when the latter institutions were established, were notably higher than the rates of interest paid locally.

As the SFH system is based on the PLS system, deposit funds collected from the public do not constitute an ultimate liability for these institutions. When, for example, there is a decline in their assets due to a loss incurred in a business project, the decline on the asset side is automatically offset by a write-off in participation deposits (provided that the loss-incurring transaction had been financed from out of participation deposit funds).

There is thus an automatic and instantaneous adjustment of the balance sheet. In the commercial banking system, however, adjustment of a bank's balance sheet to a decline in assets can create serious liquidity problems for

Table 5.3: Fund collection by SFHs and commercial banks in Turkey (billion Turkish Lira)

						% change				
	1994	1993	1992	1991	1990	1994	1993	1992	1991	1990
Current and participation accounts of SFHs	33,616 ¹	14,055	6,245	2,648	1,200	139.0	125.0	136.0	121.0	74.0
Commercial bank deposits	1,220,000 ²	522,292	294,059	164,677	93,934	134.0	78.0	79.0	75.0	52.0
Current and participation accounts/ commercial bank deposits (%)	2.75	2.69	2.12	1.60	1.27	—	—	—	—	—
Inflation rate ³	—	—	—	—	—	149.6	60.3	61.4	59.2	48.6

Notes: 1. Relative shares of existing SFHs in total funds collected by the SFH sector (as of end of 1994):

SFH	Market share in terms of funds collected (%)
1. Al-Baraka Turkish Finance House	44.00
2. Faisal Finance Institution	23.30
3. Kuwait Turkish Finance House	22.80
4. Anatolian Finance House	9.90
Total	100.00

2. Provisional as of December 16.

3. Measured by the December-on-December annual percentage change in the SIS wholesale price index.

Table 5.4: *Rates of return on SFH foreign-currency participation accounts and commercial-bank foreign currency deposit accounts (per US\$1,000 and DM1,000)*

1995 ¹	SFH participation accounts ²		Commercial-bank deposit accounts ³	
	US\$	DM	US\$	DM
One-month	4.80	3.21	0.75	0.75
Three-months	9.65	9.42	5.68	11.30
Six-months	19.21	19.03	15.90	27.12
One-year	43.39	46.75	40.90	63.29

Notes: 1. As of end of January 1995.

2. Net rate of return (after deducting 10.6 per cent withholding tax & fund); average of SFHs.

3. Net rate of return (after deducting 10.6 per cent withholding tax & fund); average of commercial banks.

Table 5.5a: *The share of SFHs in the Turkish economy (deposits) (million TL)*

Year	I Commercial bank deposits	II SFH deposits	II/I × 100 (%)
1985	7,998,900	28,893	0.36
1986	11,533,800	75,823	0.66
1987	16,440,800	148,688	0.96
1988	25,238,900	327,033	1.30
1989	40,926,000	688,000	1.68
1990	59,928,000	1,312,751	2.19
1991	92,026,000	2,593,959	2.82

Table 5.5b: *Number of branches in 1991*

	No. of branches
Commercial banks	6,727
SFHs	21

the bank which would call for costly liability management. For instance, it may have to raise its deposit interest rates drastically in order to encourage fresh funds into the bank.

A macro-economic implication of what has been mentioned above is that an economy is likely to adjust to macro-economic disturbances in a smoother, speedier and less costly manner under the SFH system than under the

Table 5.6: *Comparison between conventional banks and SFHs in terms of funds utilized*

Year	Commercial bank credits	SFH funds utilized	%
1985	5,604,600	27,086	0.48
1986	7,683,700	71,854	0.93
1987	12,312,400	123,724	1.00
1988	15,806,000	275,669	1.74
1989	25,864,000	682,000	2.63
1990	47,828,000	1,212,592	2.50
1991	72,563,000	2,392,526	3.30

Table 5.7: *Comparison between rates of return of conventional banks and SFHs*

Year	Interest payable on bank deposits (%)	Profit share distributed by SFH to depositors (%)
1985	10.05	11.37
1986	8.05	11.38-10.60
1987	7.82	9.37-10.62
1988(a)	10.05	12.03-12.98
1989(b)	12.40	11.58-13.69
1990	10.06 ³	10.02 ³
1991	13,4767 ³	14,075 ³

Notes: 1. Between February and October.

2. Weighted average of the banks.

3. First six months.

commercial banking system. The following is an extract from a paper given to the International Conference on Islamic Banking and Finance (Buyukdeniz, 1995).

A comparative financial analysis of SFHs and commercial banks in Turkey

Given the structural differences between SFHs and commercial banks, a meaningful comparison of the financial tables of these two types of institutions must duly take into account such differences.

Asset structure

A comparison of Tables 5.8 and 5.9 suggests that the commercial banks seemingly have a higher liquidity than SFHs. Accordingly, whilst the ratio of liquid assets to total assets was around 27 per cent (in 1993) for the commercial

5.8: *Asset structure of SFHs (%)*

	1993	1992	1991	1990
Liquid assets/total assets	9.20	12.40	14.50	10.00
Funds placed/total assets	83.65	73.85	68.50	69.25
Fixed assets & participations/total assets	3.17	9.00	11.23	14.57
Overdue receivables/total assets	0.49	0.47	1.25	1.68
Overdue receivables/unds placed	0.58	0.63	1.83	2.42

5.9: *Asset structure of commercial banks (%)*

	1993	1992	1991	1990
Liquid assets/total assets	26.80	22.20	17.60	16.50
Loans extended/total assets	39.70	41.30	42.00	46.00
Fixed assets & participations/total assets	6.75	7.15	7.35	7.90
Overdue receivables/total assets	0.53	0.60	0.90	0.60
Overdue receivables/funds placed	1.30	1.50	2.10	1.30
Government debt instruments/total assets	9.70	10.10	11.00	9.70

banks, this ratio was lower in the case of SFHs (around 9–10 per cent). But this conclusion is rather misleading as SFHs keep a considerable portion of their liquid funds in short-term income-earning liquid investments (e.g. commodity trade transactions with various Western financial institutions) which come under Funds Placed. Given the relatively short-term nature of participation deposit funds collected by SFHs in Turkey (under high and volatile inflationary conditions), the SFHs prefer to maintain sufficient liquidity at the expense of perhaps lower profitability, in order to meet their payment obligations in a timely and orderly manner.

In this connection, it is well worth noting that the existing SFHs in Turkey did not experience any major difficulty during the recent financial crisis (the first half of 1994), and they were able to meet their payment obligations in a timely manner without any resort to the Central Bank or outside sources for additional liquidity. In 1993 (and also in 1994), the SFHs channelled nearly 80 per cent of their available funds into commercial and industrial activities in the form of *murābahah* (trade financing) and financial leasing, and to a lesser extent in the form of *mushārakah* and *muḍārabah* (profit-and-loss sharing business projects). In 1993 funds placed by SFHs stood at around 84 per cent of their total assets, which compares favourably with the 69 per cent back in 1990. Commercial banks on the other hand channelled a lower percentage of their available funds into commercial and industrial areas; in 1993, loans extended by commercial banks into commerce and industry stood at around 40 per cent of their total assets, which marks a decline from the 46

per cent level in 1990. It is worth noting that the volume of government debt instruments purchased by the banks was around 10 per cent of their total assets. In recent years, the commercial banks tended to channel an increasingly higher proportion of their available funds into Treasury bills and government bonds offered to the public (largely to banks) at exorbitantly high interest rates (interest payable on government debt instruments are substantially over the market averages together with considerable tax advantages granted to these instruments). In short, whilst only 40 per cent of the commercial bank assets consisted of funds made available to the productive economy (into commercial and industrial uses), SFHs were able to allocate as high as 80–85 per cent of their assets into industrial and commercial uses.

The SFHs behave quite selectively in determining their credit client portfolio. An outstanding proportion of their clients are well-reputed, financially strong companies in the most dynamic sectors of the economy. The very low percentage of overdue receivables gives a good idea about the quality of their credit portfolio. In 1993, the ratio of overdue receivables to total assets was as low as 0.49 per cent (down from 1.68 per cent in 1990), whilst the ratio of overdue receivables to total funds placed stood at around 0.58 per cent (down from 2.42 per cent in 1990). These ratios compare favourably with those of commercial banks. In 1993, the ratio of overdue receivables to total assets and the ratio of overdue receivables to loans extended was somewhat higher in the case of commercial banks, standing at 0.53 per cent and 1.30 per cent respectively.

Given also the fact that a considerable proportion of the commercial banks' total assets consists of risk-free government debt instruments (SFHs purchase no government debt or any other debt instrument because of interest reasons) this also indicates to the successful management of SFHs investment policies in a high inflation, high interest-rate, high corporate-risk environment.

Liability structure

In 1993, current accounts and participation accounts constituted around 93 per cent of SFHs total liabilities (Table 5.10) whilst the ratio of total deposits to commercial banks' total liabilities was nearly 51 per cent (Table 5.11). The ratio of total equity to total liabilities was 6.70 per cent in the case of commercial banks and lower (3.30 per cent) in the case of SFHs, suggesting at first glance existence of a capital inadequacy problem for SFHs. But such a conclusion is rather incorrect and misleading for the following reason.

For a conventional bank, funds collected under current and time deposit accounts constitute an ultimate liability as the principal (amount deposited) and a fixed (predetermined) rate of return (i.e. interest income) are fully guaranteed by the bank. In other words, there exists a debtor–creditor relationship between the depositor (creditor) and the bank (debtor). It is a

Table 5.10: *Liability structure of SFHs (%)*

	1993	1992	1991	1990
(Current accounts & participation accounts)/total liabilities	83.20	79.20	73.70	69.30
(Current accounts & participation accounts)/total equity	2492.00	2124.00	1504.00	1263.00
Funds borrowed/total equity	0	0	0	0
Total equity/total liabilities	3.30	3.72	4.90	5.49

Table 5.11: *Liability structure of commercial banks (%)*

	1993	1992	1991	1990
Deposits/total liabilities	50.80	55.25	57.20	56.60
Funds borrowed/total liabilities	27.68	22.35	19.50	20.82
Deposits/equity	759.00	814.00	828.00	804.00
Total equity/total liabilities	6.70	6.80	6.90	7.00

definite and unconditional commitment for a deposit-taking bank to pay at the maturity date the principal plus the interest income. The meaning of deposit is fundamentally different within the context of interest-free banking. In essence, an interest-free bank resembles an open-ended mutual fund. A depositor deciding to open a profit-and-loss participation deposit account with an interest-free bank, is not a creditor to the bank; instead he/she is a capital-owner authorizing the bank to manage his/her funds in the best possible manner. This is a typical partnership, whereby the two parties become partners to do business, one party being the manager of funds (the bank) and the depositor being the capital-owner. Therefore, funds deposited with an interest free bank are not a commitment for the bank, as neither the principal amount nor any predetermined rate of return is guaranteed to the depositor. Whilst participation deposits are shown on the liability side of the bank's balance sheet, it is not a liability in the true sense of the word.

Return on equity and assets

Return on Equity (the ratio of profit to total equity) is higher for the existing SFHs than for the commercial banks. In 1993, the return on equity was 46.2 per cent for the SFHs, whilst it was lower (40.7 per cent) for the commercial banks (see Table 5.12).

Return on assets (the ratio of profit to assets) is higher for the commercial banks and lower for the SFHs. In 1993, the return on assets was 2.72 per cent for the commercial banks and 1.54 per cent for the SFHs.

Table 5.12: *Return on equity and assets (%)*

	1993	1992	1991	1990
<i>Profit/total assets</i>				
Commercial banks	2.72	2.40	2.33	2.28
SFHs	1.54	1.37	2.22	2.25
<i>Profit/total equity</i>				
Commercial banks	40.70	36.10	33.80	32.40
SFHs	46.20	36.70	45.50	41.00
Inflation rate	60.30	61.40	59.20	48.60

It may be noted that within the present climate of banking in Turkey, there is plenty of opportunity for the special finance houses to flourish. This is due to the fact that this experiment offers two major things for its clients: the first being *halāl* investments and the second profitable investments.

So it appears more than likely that SFHs will continue their rapid growth within the Turkish financial market. But despite the successes of the special finance houses in the Turkish financial market, the evidence does confirm the view of ABT's management, that SFHs in Turkey, for the foreseeable future, will remain a minority subsector.

Al-Baraka Turk

Objectives

In order to bring the subject closer to the reader the authors decided to analyse a specific case, Al-Baraka Turkish Finance House (Al-Baraka Turk). The main objectives and activities of Al-Baraka Turk are as stated in its Articles of Incorporation (Al-Baraka Turk, 1991):

- To provide an economic and financial system based on co-operation for the welfare of society in keeping with norms of justice and benevolence.
- In addition to the capital of the company, to attract funds and encourage investors to participate on a non-interest basis. To finance all kinds of agricultural, industrial and commercial activities and services in joint investments. To issue letters of guarantee. To finance imports and exports. To obtain equipment related to investments and to sell the same by instalments or by leasing them.
- To coordinate scientific and technical expertise and know-how, and direct the same within a commercial context to serve the welfare of the society.
- To assist small investors/traders who have experience but lack the necessary capital, as a part of the economic development of the society.
- To undertake all types of trade and buy/sell commodities in money/trade

markets without exploitation, provided that it is permitted under relevant Turkish law.

- To provide technical, economic, financial and administrative consultancy services and prepare investments and economic feasibility studies for projects intended to be established, and to undertake on behalf of investors the research and evaluation of projects and identification of investment opportunities.

Business relationship with other financial institutions

Competition exists between the Islamic finance houses and more than 50 *ribā*-based conventional banks. Al-Baraka Turk does deal with these conventional banks. It keeps current accounts with some of them because they have many branches. It also enters into deposit-collecting agreements with some of them allowing them to collect deposits for it where it does not have branches. The conventional banks do this for Al-Baraka because it does not take interest for its deposits with them. Al-Baraka has a worldwide network of correspondent banks in most parts of the world. Baldwin (1990) states that Al-Baraka Turk prefers, wherever possible, to use the services of other Islamic banks rather than those of conventional banks. In interviews, three managers of Al-Baraka Turk were asked whether their institution reaps any advantages from being Islamic and having a worldwide network of contacts. The reply was: 'No; because of a lack of co-ordination with other Islamic banks and because of the competition between us'.

Fund collection

Current accounts

These are demand deposits which may be withdrawn in whole or part on request. They may be opened in Turkish currency. Withdrawals are made in the currency in which the account is opened. Current accounts may be opened in the name of the depositor or they may be 'bearer' (anonymous) accounts. Current accounts may always be closed on demand and the holders of such accounts are paid neither interest nor profit in any form whatever. Current accounts are underwritten (guaranteed) by Al-Baraka Turk.

At present, current accounts constitute a relatively small proportion – around 5–6 per cent of total funds collected by the SFH. (The share of interest-bearing current deposits in total commercial deposits is around 25–30 per cent). The smaller share of current accounts in SFHs is due largely to the finance houses methods of financing which differ substantially from those of commercial banks. A commercial bank extends financing to its clients in the form of cash advances, by crediting the client's current account held with the bank, which generally leaves a residual deposit balance in the account as the

client usually draws down gradually from the account. An SFH, on the other hand, extends financing to its clients in kind, such as *murābahah* and leasing, rather than in the form of cash advances.

SFHs' relatively smaller share of current accounts can also be attributed to their limited number of branches throughout the country, which naturally limits their ability to provide efficient and fast current-account services in localities where they do not have a branch network. At present, the total number of SFH branches is 45 as against the 6,157 commercial bank branches.

Participation accounts

These accounts, which may be held in Turkish or foreign currency, are opened by signing a profit-and-loss participation account contract between the account holder and the SFH. The account holder, by opening a participation account, authorizes the SFH to manage his/her funds against a certain agreed management fee (*mudārib* share). The account holder participates in the profit-and-loss of the investment pool fund in which he invests.

For these accounts neither the principal nor any return is guaranteed or predetermined for the depositor. Instead, the depositor becomes a participant in the average profitability or loss of the funds managed by the bank.

Participation accounts may be opened in the name of the depositor or they may be bearer accounts of parties who wish to share in the SFH profits (or losses) for periods of 90 days, 180 days, 360 days or longer, with a maximum of five years. Money may be withdrawn from participation accounts prior to maturity provided 30 days' prior notice is given by the account holder. In case of withdrawal before maturity, if the pool in which the money is invested has recorded a profit between the date of investment and the date at which the prior notice of withdrawal is given, the accumulated profit accruing to the account is refunded to the pool for redistribution amongst the remaining participation depositors. If the pool has recorded a loss between the date of investment and the date of prior notice the withdrawing account holder participates in the loss according to his share in the pool.

Participation funds collected by the SFHs are of a short-term nature, the average period not usually exceeding 4-5 months.

In the case of Al-Baraka Turk the share in the profit and loss resulting from the placement of funds in these accounts is a maximum of 20 per cent (that is, the 'management share'). The profit or loss is calculated on a weekly basis as mentioned before. Al-Baraka Turk also operates a special investment account. This offers investors with a minimum deposit of TL60 million a higher return. The investor receives 90 per cent of all profit and Al-Baraka takes 10 per cent as management expenses. Funds may be placed for 180 days, 360 days or longer. These funds are not covered by the Saving Deposit Insurance Houses.

Like the commercial banks, since 1988, SFHs in Turkey have not been

Table 5.13: *Relative importance of various financial instruments in the Turkish financial system (% share)*

	1993	1992	1991	1990	1989
Currency in circulation	5.74	6.15	7.01	8.67	7.74
Bank deposits	49.04	55.50	59.81	59.81	63.74
SFH participation and current accounts	1.54	1.25	1.00	0.82	0.76
Government borrowing instruments ¹	27.68	23.14	16.90	17.39	17.17
Private-sector financial instruments ²	12.12	10.35	13.05	10.98	8.82
Others ³	3.88	4.86	2.23	2.33	1.77
Total ⁴	100.00	100.00	100.00	100.00	100.00

Notes: 1. Government bonds, treasury bills, revenue sharing certificates and foreign currency indexed bonds.

2. Shares, bonds and commercial papers.

3. Insurance premiums, financial leasing contracts (excluding cross-border leasing) and VDMK (asset-backed bank borrowing papers).

4. The total value of financial assets had reached TL914,170 billion (equivalent to US\$ 106.8 billion) by the end of 1993.

allowed to open anonymous (bearer) current or participation deposit accounts in foreign currency (monetary authority regulations).

Other services

Al-Baraka Turk provides the following additional services to its customers:

- to effect inward and outward remittances;
- to draw up, prepare and accept bills, promissory notes, dividend certificates, cheques, bills of lading, debentures and other instruments, and to endorse the same;
- to purchase and sell foreign currency on the spot market;
- to open, advise and confirm letters of credit;
- to issue travellers' cheques;
- to act as trustee and attorney, to manage stocks, profit-sharing certificates, bonds, debentures and portfolios related to these.

Function

Al-Baraka Turk's aim, as one of its board members stated, is to attract the funds of Muslims, especially those who are reluctant to deposit their savings in conventional banks because of interest and prefer to 'hide it under their mattresses', and to inject those savings into the Turkish economy, and, in

addition, to attract Muslim capital from abroad. In explanation of the general role of Al-Baraka Turk, its general manager said in an interview:

It is to make Islamic investments with no *ribā* for those people who have funds but do not want to invest them in a *ḥarām* way, and cannot leave their money deteriorating in value by 75 per cent inflation per year. Al-Baraka Turk's role is to provide *ḥalāl* investments, *ḥalāl* facilities and *ḥalāl* profit.

When the deputy chairman of Al-Baraka Turk and one of the board members were asked whether the finance house was a profit-seeking or a social-development institution, both answered as follows: 'We consider ourselves as a profit-making institution, keeping within the norms of justice and benevolence. We do not have any more responsibility than the conventional banks towards the development of the society.' Ten clients of Al-Baraka Turk were asked their opinion of what the characteristics of the SFHs should be. All of them put working under Islamic law as the first priority; the second was protection of deposits against inflation through adequate financial yields; the services they received from the bank and the staff's attitude towards the clients came last. When we asked them whether they were satisfied with Al-Baraka Turk generally, the answers were affirmative.

Priorities and conformity to Islamic values

As stated above, the Turkish authorities do not recognize any such thing as Islamic banking; nor are the SFHs allowed to include terms like Islam or *Shari'ah* in their documents and advertisements, nor even to have a *Shari'ah* consultant or adviser for Islamic transactions. The implementation of *Shari'ah* in Al-Baraka Turk, therefore, is informal rather than formal, and depends wholly on how knowledgeable its managers are in Islamic law.

With regard to ethical banking and social responsibility, Al-Baraka Turk is consciously making all its investments in the norms and values of Islam, within the limits previously explained, with a verbal emphasis on being the first financial institution in the country not to contradict Islamic principles. As for specific socially responsible investments, a senior manager in Al-Baraka Turk stated that, to date, the bank had done nothing in this regard.

Asked about Al-Baraka Turk's investment criteria, the general manager said that: (a) nothing in a proposed deal should contradict Islamic norms and values; (b) the choices must be made on the grounds of profitability of return for depositors and shareholders. He commented further:

We are not a charity. We do not work only for religious beliefs. We also have to be competent. We continue to be successful and the people will continue to come to us. We have to be trusted and be knowledgeable and we should say that Islamic banks do not cover all economic activities. Not all people prefer to use us. Therefore,

we will not take over; we will keep playing a complementary role not an alternative one.

Management

Al-Baraka Turk is governed by a board of directors comprising the main shareholders. The general manager is responsible for the running of the bank's operations. Al-Baraka Turk now has ten branches in Turkey. In an interview, the general manager pointed out that one of the distinguishing features of Al-Baraka Turk's experience of Islamic banking in Turkey is that SFHs compete not only in the market with conventional banks but also between themselves. He considers this a healthy situation: (a) if there are more Islamic banks more people will know about Islamic banking; and (b) competition forces each bank to give better services.

The stability and homogeneity in the management personnel at Al-Baraka Turk were given by the deputy chairman and the general manager as two of the most important reasons for the institution's success. Our study showed that the Al-Baraka Turk employees were enthusiastic about their work. As to the major obstacles facing the finance house, the chairman and general manager indicated the following:

- finding suitable staff to work in Islamic banking who have knowledge of both *Shari'ah* and banking;
- the fact that the clients' attitude remains one of suspicion;
- the attitude of successive governments. The SFHs face the additional obstacle of how to operate in a secular state. (When asked to explain further, they said: 'We do not want protection. All that we want from the central bank is to let us be equal in the advantages (tax advantages, number of branches). Any conventional bank needs one billion Turkish lira to open a branch, we need five billion. A conventional bank's depositors are protected by the government, ours are not. Our responsibility is a very heavy one');
- the impermissibility (under *Shari'ah* law) of giving cash credit;
- the burden of inflation. Al-Baraka Turk does not enter into any deals of a term longer than one year because of inflation; it deals with a high rate of inflation usually by distributing profit at least above the rate of inflation;
- cash surplus. There are not enough investment opportunities to match the liquidity which Al-Baraka Turk enjoys. Further, it cannot deposit this money, for example as an overnight deposit in another conventional bank, and get interest, so this is a problem.

During an interview, one executive and four managers were asked whether the transactions in Al-Baraka Turk took more time or cost more than the

aconventional bank. The answer was that the situation was comparable and that they were looking to improve matters even further.

Marketing and client services

Al-Baraka Turk does have a marketing department which is trying to encourage people to deposit with the bank on the grounds that it applies certain Islamic principles and at the same time distributes good profit. The content of all advertisements is strictly regulated and monitored by the under secretary of the Treasury and Foreign Trade who issues detailed rules for the SFHs regarding their publicity and advertisements: all media advertisements must avoid the use of the words Islam or *Shari'ah*.

Al-Baraka Turk publishes the revalued profit figure of its Turkish lira and foreign-currency accounts every Tuesday in one of the main Turkish newspapers.

As of April 1992, Al-Baraka Turk had 66,000 depositors holding leasing and participation accounts, and 17,774 depositors holding current accounts.

In interviews, ten clients of Al-Baraka Turk were asked what had led them to deposit their money with the finance house. The majority (six out of ten) gave the reason as 'Islam'; a significant minority said the reason was that it offered a good service.

Baldwin (1990) stated that: 'Despite the fact that the market-share captured by the Finance Houses is steadily increasing, it appears that this is a result of these institutions offering financial products which appeal to believers and not as a result of direct competition with *riba* banks.' From the above, it appears that Islam has played a major role in attracting depositors and in the success of these SFHs, but the quality of services offered to clients has also (been) a significant factor.

Table 5.14 below shows figures which compare Al-Baraka Turk's position *vis-à-vis* other SFHs.

It shows the comparative position in terms of the funds collected, funds utilized and profits gained. As it is first in all areas, it seems only right to observe that in this case Al-Baraka Turk has achieved the greatest absolute level of profit, while Kuwait Evkaf achieved the best return on assets com-

Table 5.14: *Interest-free banking sector in Turkey: an intra-sectoral comparison, 1991 (million TL)*

	ABAT	Kuwait Evkaf	Faisal	Total
Funds collected	1,378,525	403,670	811,762	2,593,959
Funds utilized	1,383,924	308,438	700,164	2,392,526
Paid-in capital	30,000	20,434	25,000	85,000
Profit	43,829	20,434	14,948	79,211

pared to the others. When a comparison is made among the SFHs, Islam must be excluded as a reason for dealing with Al-Baraka because all the SFHs have the same criteria in that they invest in an Islamic way. Competition between the SFHs exists on a purely commercial level.

CHAPTER 6

Islamic Banking in Malaysia

The development of Islamic banking in Malaysia is a very interesting phenomenon. It is no exaggeration to say that it is the most exciting phenomenon in Islamic banking. Its rapid growth within favourable economic conditions has attracted the attention of many financial institutions in Islamic and Western countries. Islamic banking facilities are currently offered by more than 23 banks and financial institutions in the country. However, only one of these can be considered as an Islamic bank (Bank Islam Malaysia), while the others are mainly conventional institutions.

Observers of the development of Islamic banking have remarked on two approaches to its evolution: either one or few Islamic banks have struggled in a conventional banking environment or the banking system as a whole has been Islamized, as is the case in Sudan, Iran and Pakistan. Malaysia has pursued the unique approach of a dual system where conventional and Islamic systems exist side by side, and (unlike Jordan) opportunity is given to all banks to practise Islamic banking, if certain terms and conditions are met. Islamic banking in Malaysia is unique also for the reason that the market is a well-developed one with a huge future potential. This is demonstrated by the fact that GDP growth has sustained its momentum by more than 8 per cent in the period 1988–95. This makes the Malaysian model a unique one compared to other countries who have been facing economic difficulties during the period that they adapted their banking system.

Growth of Islamic banking

There are many factors that contribute to the successful growth of Islamic banking in Malaysia. The first factor is the encouragement and support of the monetary authorities. Both the Ministry of Finance and the central bank are very supportive of Islamic banking. For example, they were both involved in the establishment of the Islamic Inter-bank Money market (IIMM). This scheme, introduced on 3 January 1994, is a major step forward in facilitating the Islamic banking movement. Even though few financial institutions participated in the founding of the scheme, the volume of trading (Malaysian ringgit 1,500 million in the first six months) is expected to increase dramatically, as the facility becomes better known. Utilization of this and similar facilities will

pick-up further with an increase in the use of new Islamic financial instruments and with products being developed. A further demonstration of the government's initiative in supporting Islamic banking is the flexibility in the IFBS (interest-free banking scheme), which allows banks and financial institutions to negotiate the ratio of profit sharing together with the central bank. It should be borne in mind, however that too much flexibility and frequent changes in regulation, if not carefully planned and handled, could create confusion among the participants in the market.

The second factor that contributed to the rapid emergence of Islamic banking in Malaysia, is the creativity of financial engineering, in designing new products. For example, Malaysia was the first country to introduce mortgage bonds, in 1994. The MR30 million Cagamas *mudārabah* bonds, the first of a series, will be used to purchase housing loans from Bank Islam Malaysia Berhad (BIMB). The bond will be based on the profit-sharing principle and the profits generated will be shared according to an agreed ratio.

The third factor at work is the current intense competition for foreign capital. The insufficiency of foreign capital, alongside the opening up markets in China and Vietnam, will lead to a serious shortfall in the foreign capital required to sustain the high growth of the Malaysian economy, which is expected to exceed 8 per cent a year over the next few years. The measures in hand to stimulate domestic investment institutions, such as Islamic banking, are the only way of decreasing reliance on foreign capital while also attracting oil money funds to Malaysia.

The fourth factor is the favourable economic environment, with its attractive fiscal incentives, together with political stability. Malaysia provides such incentives as flexibility in ownership control and foreign-exchange restrictions, and streamlined administrative procedures, while the country has a stable government and clear development policies.

In 1993, the banking structure was made up of 38 banks, 16 of them foreign-owned, with total assets of MR222.2 billion. The operation of conventional banks had expanded rapidly, with a 27.7 per cent increase over the previous year. Total deposits (excluding repose) were MR132.211 billion, which represents a 24.7 per cent growth over 1992 figures. The branch network consisted of 1,220 branches, 1,074 domestic and 146 foreign-owned. Even though there are currently 16 foreign banks active in Malaysia under the local incorporation exercise, all foreign banks are required to commence their operations as locally incorporated banks.

In order to promote Islamic banking, the Malaysian government issued the Islamic Banking Act of Malaysia in 1982. The act, with its subsequent amendments, provides strict but flexible regulations and supervision for financial transactions in Islamic banking. Furthermore, the act expects the highest ethical standards and sound management for executives working in Islamic banks, otherwise hefty fines and imprisonment are applied (section 47). To enhance the ability of Islamic banks to invest their liquid assets, the government issued

the Government Investment Act in 1983. This act empowers the government to issue government investment certificates which are founded on an Islamic basis.

BIMB, which was established in 1982, is the only bank, in Malaysia whose entire operations and regulations are interest-free. The bank, which was listed in the Stock Exchange in 1992, offers all kinds of conventional banking services based on *Shari'ah* principles, in addition to deposits based on the principle of *mudārabah*. The bank was active in creating new products, such as Islamically Accepted Bills and Islamic Export Credit Refinancing. Total resources of the bank have increased twelve-fold in ten years and had reached MR2 billion in 1993. Though the magnitude of the impact on BIMB of opening up Islamic banking to other banks is not yet clear, it is clear that in the long run there will be intense competition. To deal with the expected competition, BIMB is implementing a strategy designed to reach potential customers so far uncatered for.

In order to increase the number of participants or players in Islamic banking, the government decided in March 1993 to permit three banks, under the IFBS', *Skim Perbankern Tanpa Faedah* (SPTF), to open interest-free counters and offer Islamic banking services. The three are: the Malayan Banking Berhad (May Bank), Bank Bumiputra Malaysia Berhad (BBMB) and the United Malayan Banking Corporation (UMBC).

The number of branches that offer such services has shown a substantial increase from the existing 146 branches in May 1993. During 1993 and up to the second quarter of 1994, more financial institutions joined the SPTF, which brought the total number of participants to twenty-three. This includes 13 commercial banks, 2 merchant banks, 8 financial companies and 1 Islamic bank (BIMB). By the end of 1993, total deposits in accordance with *Shari'ah* were MR2050 million, of which MR1801 million (88 per cent of total) were with BIMB and the other MR249 million (12 per cent) with other SPTF institutions. Total deposits of Islamic banking represent 1.55 per cent of the deposits of all banks.

Under SPTF, all commercial and merchant banks, and finance companies are allowed to deal in Islamic transactions provided they fulfil a number of requirements, the first of which is to establish an interest-free banking unit at the parent bank; the second requirement is to create and maintain an interest-free banking fund. This is a working fund, provided by the parent bank, to cover overheads and other operating costs.

Some of the banks which were prepared to offer Islamic banking products to the public under SPTF viewed Islamic banking operations as a niche in the market that had the potential to become dominant and offered a range of products, including current accounts, saving accounts and leasing. Other banks in the SPTF scheme did not see Islamic banking as a core activity in their business but, instead, as a particular banking service that could enhance

their position and expand their business in the market: such banks confined themselves to limited products such as saving accounts, and few branches.

In its effort to support the Islamic banking movement, a wide variety of Islamic financial products and instruments was introduced by the Bank Negara (the Central Bank). Up to 1993, it had launched more than 21 products and instruments. At the beginning of 1994, it created the Islamic interbank cheque-clearing system. This facility provides a separate cheque-clearing arrangement for those banks participating in the Islamic banking scheme. The clearing process and its regulations are all based on the *mudārabah* principle. Such a scheme could not have been realized without the support of Bank Negara, extended in the form of short-term funding, if needed, on the same *mudārabah* principle.

With such political decisiveness and favourable economic conditions, it is expected that in the near future all financial institutions in Malaysia will adopt the interest-free banking system alongside that of conventional banking. This includes 38 commercial banks, including 16 foreign-owned banks, 12 merchant banks and 41 financial companies currently operating in the country. This means that Malaysia will be the first Islamic country to have a comprehensive and efficient Islamic banking system side by side with a conventional banking system.

The Malaysian experience of Islamic banking has had a tremendous impact on neighbouring countries. Brunei Darussalam created its first Islamic bank in 1993. Indonesia established its first Islamic bank in 1992 (Bank Muamalat), and many more are expected to be licensed there soon. Even Singapore has shown its acceptance by allowing the implementation of an Islamic-style banking system for private banks.

The continued success of Islamic banking in Malaysia will depend on its efficiency and profitability and its competitiveness with interest-bearing investments. The system must give proper consideration to the need to minimize the risk to customers and to the legitimacy of its operations from the *Shari'ah* point of view. Since Islamic banking in Malaysia has an impact beyond national boundaries, its operations should not be subject to *Shari'ah* scrutiny only by *Shari'ah* scholars in Malaysia, but also include eminent scholars from other countries around the world. The Malaysian experiment is fascinating and rich, illustrating the effectiveness of a pragmatic approach to solving the chronic problems of Islamic banking. Such experiments need to be supported, encouraged and guided by all beneficiaries and participants.

Derivatives, and the Challenges in the Development of Islamic Secondary-Market Instruments: The Experience of the Islamic Development Bank

This chapter will deal with two important developments in the contemporary financial markets: Islamic banking, with special emphasis on the Islamic Development Bank (IDB) and derivative contracts. The chapter will first describe the establishment of the IDB and its activities and later the general relevance of Islamic financing will be discussed. Then, we will share with the reader our feelings about the prospects of initiating a discussion on the possible place for derivative contracts within the framework of Islamic financing; finally we will describe the role of the IDB in promoting Islamic secondary markets.

Overview of the Islamic Development Bank (IDB)¹

The IDB is the premier Islamic financing institution and the only one of its kind. It was established following a meeting of the finance ministers of Islamic countries held in 1973 in Jeddah, Saudi Arabia, in which the feasibility of an international development bank was discussed. The inter-governmental Islamic institution that opened its doors to the public on 20 October 1975, also in Jeddah, was named the Islamic Development Bank.

Objectives

The objectives of the bank, as set out in its Articles of Agreement (IDB, 1981a), are:

- to meet the need to foster the well-being of the people of Muslim countries and to achieve a harmonious and balanced development in those countries on the basis of Islamic principles and ideals;
- to meet the need for mutual financial and economic co-operation among the Muslim states in economic, social and other fields;
- to meet the need to mobilize financial and other resources both from within and outside the member countries, and to promote domestic savings and

investments and a greater flow of development funds into member countries.

The charter of the bank stipulates that the international financial institution being established shall be oriented to development, investment and welfare, be based on Islamic principles and ideals, and be a practical expression of the unity and solidarity of the Muslim *ummah*.

More specifically, the purpose of the bank as expressed in Article 1 is to foster economic development and social progress in member countries and Muslim communities, separately as well as jointly, in accordance with the principles of *Shari'ah*.

In this regard, two facts deserve special mention: first, that the mission and task assigned to the bank embraces the Muslim nation (*ummah*) as a whole and is not confined to only the member countries; second, while the bank is required to operate in accordance with the principles of *Shari'ah*, this is a broad and general requirement applying to all the bank's activities. Beyond that, no guidance is provided in specific terms (Meenai, 1989).

Operations and role

The bank has been assigned the following functions and powers (IDB, 1981b):

- to participate in the equity capital of productive projects and enterprises in member countries;
- to invest in economic and social infrastructure projects in member countries through participation or other financial arrangements;
- to make loans to the private and public sectors for the financing of productive projects, enterprises and programmes in member countries;
- to establish and operate trust and special funds for specific purposes, including a fund for assistance to Muslim communities in non-member countries;
- to accept deposits and to raise funds in any other manner;
- to assist in the promotion of foreign trade, especially in capital goods, among member countries;
- to invest surplus funds not needed in its operations;
- to provide technical assistance to member countries;
- to extend training facilities for personnel engaged in development activities in member countries;
- to undertake the research necessary to enable the economic, financial and banking activities in Muslim countries conform to *Shari'ah*;
- to co-operate in such a manner as the bank may deem appropriate with all bodies, institutions and organizations having similar purposes, in pursuance of international economic co-operation; and
- to undertake any other activities which may advance its purpose.

The foregoing list clearly demonstrates that the bank has been assigned a wide-ranging set of tasks which in many ways exceeds the functions assigned to other international development banks (Meenai, 1989). For example, the bank deviates from the mainstream of other development institutions because it is heavily involved in the promotion of trade among its member countries. Trade financing has been an important part of the overall financing activities of the bank, representing 80 per cent of its operations and contributing 30–40 per cent of its income. It has also been one of the most effective ways in which the bank has been able to promote co-operation among its member countries. Such co-operation is promoted through many schemes, for example: Import Trade Financing Operations (ITFO), Islamic Banks' Portfolio (IBP), Longer-Term Trade Financing Scheme (LTTFS) and Islamic Co-operation for the Insurance of Investment and Export Credit. The bank has been active in other functions, as well, such as helping member countries at times of natural disasters and upgrading the economic and social status of Muslim communities in non-member countries. The amount approved for such purposes stood at US\$408 million on 20 June 1993. Further, the bank launched a scholarship programme with 2,000 student recipients and a Merit Scholarship Programme for high technology, for 24 promising and prominent scholars.

Relationship with other Islamic banks

The bank's charter stipulates clearly that it should co-operate with all bodies, institutions and organizations having similar purposes in pursuance of international economic co-operation. The bank has, therefore, from its inception endeavoured to establish close relations with Islamic banks. To this end it has held extensive discussions with them, as well as maintaining ad hoc contacts. Since 1980 the IDB has organized a special meeting each year, to coincide with its annual meeting, to which the Islamic banks are invited for the purpose of discussing problems and avenues for co-operation. These meetings have proved to be very effective. The establishment of an Islamic Trading Company in 1990, the creation of the Islamic Banks' Portfolio in 1987, and the establishment of various co-ordination bodies for training, research and information are practical outcomes. In addition, such meetings have been useful in bringing common understanding and responsive action to the challenges that face Islamic banks. They have created a continuous mechanism to promote co-financing and joint investment through co-ordinating six-monthly meetings of the banks' investment managers banks, for the discussion of investment proposals.²

The number of Islamic banks in which the IDB holds equity stock is nine. The bank has an investment deposit scheme, under which member banks are able to place their surplus funds in the IDB's foreign-trade financing operations in accordance with the principles of *Shari'ah* (IDB, 1981b).

Furthermore, IDB has extended to IBP a facility of US\$70 million for financing trade syndication and another facility of US\$70 million for lease syndication. By the end of 1993, the number of IBP operations reached 59, with a total value of US\$323.12 million.

The Islamic banks, for their part, have very high expectations of the IDB, expect it to play something of a parental role, plead their case with governments and central banks of member countries and use any leverage it may have with them for the purpose of helping the Islamic banks.

In recent years, Islamic banks have evinced a growing interest in using such IDB facilities as the unit investment fund, IBP and investment deposit scheme to place their surplus funds. This is the result of several factors:

- there has been a larger inflow of deposits into these banks as they have become established and confidence in them has grown;
- the return which they offer to depositors has become especially attractive as deposit rates have generally fallen in the international money markets; and
- the IDB instruments provide Islamic banks with an attractive rate of return at a reasonable level of risk, and all funds are invested within Islamic countries.

Trading of financial certificates

Research works indicate that there is no objection in the *Shari'ah* to the issuing and trading of financial certificates. These certificates should, however, represent assets. A part of these assets may be in the form of debts created by Islamic modes, but the debt element should not be predominant. As part of the prohibition of *ribā*, Islam also forbids the sale of one instrument of debt for another. This implies that pure-debt instruments cannot be issued.

During the past two decades the appeal of Islamic banking has been on the rise. The present cumulative value of assets held by the Islamic banks is estimated at around US\$48 billion, and each year over US\$6 billion of new banking transactions are undertaken involving Islamic modes of financing. Substantial investment opportunities are generated by these activities.

Interaction between derivatives and Islamic financing

Also over the last 20 years derivative contracts have become popular in the global financial markets. Derivatives, such as interest-rate swaps and options, future commodity contracts, stock options and futures, currency futures and options, are derived from the expected future performance of the respective underlying assets. The importance of these often highly complex contracts can be understood by their market size. Different estimates put the current

value of global derivative contracts at US\$8-14 trillions. Derivatives based on interest and exchange rates, traded on OTC markets, dominate the growth trend as well as present composition of these transactions.

These contracts are often described as a mixed blessing. As a viable hedging mechanism, derivatives help in guarding against fluctuations in interest rates, stock, commodity and currency prices. At the same time they can be the basis for a potential threat to the stability of the global financial system. For instance, derivatives generate off-balance-sheet assets and liabilities but suppress the required disclosures, therefore accurate estimation of the default risk of enterprises using derivatives has almost become impossible. Moreover, due to the complexities of the contracts, many potential problems remain unidentified.

In order to avoid the possible instability of the global financial system, measures to discipline the market are being called for in different circles. These include, for example, government regulations, requirements for more disclosures, and efforts to enhance professional expertise to understand the nature of the contracts.

To understand the possibility of an interaction between the derivative contracts and Islamic financing, it may be noted that derivatives are partly a product of the increase in global risk-capital. Islamic financing, based as it is on participation, can be expected to strengthen the market for derivatives.

Nevertheless, the dominant forms of derivatives, namely interest-and currency-rate swaps and options will be out of place under Islamic financing, moreover, Islamic financing requires that in any contract for future deliveries the price must be paid in advance. This will control future speculative trading. In addition, a financial contract must not benefit one party at the expense of the other. This requires a change in the basic philosophy underlying derivatives, which often results in the separation of gainers and losers.

With these basic considerations in view, it is proposed that certain types of derivatives, mainly some modified forms of options in stocks and Islamic financial certificates, will continue to render useful functions under Islamic financing. The modifications are needed to ensure that the price paid for any option is in fact the price of the underlying asset paid in advance, rather than the price of the option itself. This is necessitated by the fact that in Islamic financing an option by itself is not recognized as a marketable asset.

It may, however, be argued that if these Islamic requirements are introduced the derivative instruments will lose their potential as a hedging mechanism and an interest in them will be lost. Derivatives may also play other useful functions within the framework of Islamic financing. To work out fully such benefits, and make use of them, substantial practical and conceptual efforts would be required.

The IDB and the development of the Islamic secondary market

The activities of the IDB are an attempt at the practical application of an Islamic financial system. The IDB was established in 1974 by the member

countries of the Organization of Islamic Conference (OIC) with the objective of fostering the economic development and social progress of member countries and Muslim communities in accordance with the principles of the *Shari'ah*. During the short period of its unique experience, the IDB has developed a number of Islamic modes of financing to back social-development projects as well as projects which can meet the criteria of the market rate of return.

A well-functioning market for derivatives is not possible without mature secondary markets for the underlying assets. The secondary market for Islamic financial certificates is in the early stages of development. The IDB, in co-operation with other Islamic banks, has undertaken serious practical efforts to initiate this market and to strengthen it. As a result, the bank has been successful in establishing two *mudārabah* funds, namely the Islamic Banks' Portfolio (IBP) and the Unit Investment Fund (UIF).

Established in 1987, the IBP aims to enhance its operations by promoting syndicated Islamic financing and, eventually, issuing tradable financial certificates. The IBP was established with a proposed capital of US\$50 million but was oversubscribed. The capital was subsequently raised to US\$65 million, US\$80 million in 1991 and US\$380 million in 1993, of which the IDB has subscribed US\$175.5 million. Including IDB, at present 22 Islamic banks are participating in the IBP.

The UIF was established by the IDB in 1990 and aims at mobilizing investible funds from the market, particularly the funds of Islamic institutional investors, by making periodic offers for subscription to the fund. The UIF is a closed-end *Shari'ah*-compatible mutual fund. The bulk of its investment is in leased assets which are acquired mostly from the prime assets in the IDB portfolio. The fund seeks to respond to three needs of the *Shari'ah* counterpart of the international capital market: (a) it offers a high-grade Islamic medium of investment; (b) it serves as a vehicle for secularization of the Islamic banks' assets; and (c) it offers more depth in the Islamic capital market by adding to the range of financial instruments enhancing efficiency of that market. So far the fund has made two issues of US\$100 million each. While the first issue was sold over a period of time, the second issue was oversubscribed by 230 per cent. The fund is planning to offer another issue of US\$300 million in several branches over the next three years. During the first four years of its operation, the UIF yielded an average annual return of 10 per cent. In this way, it has performed a catalytic function in laying the foundations of the Islamic financial market. As an asset class, UIF out-performed other similar dollar-based investment vehicles in the conventional capital market.

It is important for the UIF to cater for the needs of the investors whose main objective is to earn a return that could provide a combination of income with capital appreciation. This could have been achieved by investing in high-grade equities. However, a *Shari'ah* restriction was introduced by the Fiqh Academy of the Organization of Islamic Conference on investing in the

equities of companies which deal in interest-based transactions. To deal with this problem, the IDB has undertaken a pilot project to restructure the capital of two companies to conform fully to Islamic financing. The IDB, as *mudharib*, has also helped the UIF to emerge as a high-grade income fund by providing a master counter-guarantee for repayment of all lease-and instalment-sale assets of the fund, and by establishing a dividend equalization account to stabilize the fund's income. Until the fund is listed in stock markets, the IDB has taken on itself the role of market-maker, providing liquidity to unit holders at periodic intervals. It is noteworthy, however, that during the nearly five years of the fund's operations, the unit holders have not had any recourse to the facility, which demonstrates their confidence in the fund.

As international capital market *mudarabah* funds, both the IBP and the UIF face the challenge of innovating marketable Islamic financial certificates. The funds available to Islamic banks in the form of deposits are short-term in nature whereas project-financing is a medium-to long-term activity. Matching these considerations, particularly with respect to the calculation and payment of return during the gestation period of a beneficiary project, is clearly a difficulty that needs to be overcome. Adaptation of a suitable Islamic benchmark rate of return, for example, as a substitute for LIBOR or return on US treasury bills is another major challenge.

Apart from these considerations, the development of *Shari'ah* compatible derivative instruments is a challenging undertaking in itself. One possible use of a derivative contract may be in enhancing the mobilization of funds by promoting instalment purchase. In this regard, two types of future options may be proposed for *Shari'ah* and economic evaluation: the first may be called an offer to buy the stocks or financial certificates of the enterprise by the instalment supplier within a specified time period on a specified price; and the second may be called the offer to convert instalment sale liabilities by the instalment supplier into the common stock or financial certificate of the enterprise. In addition, a company may also act to undertake future delivery of an asset on the basis of a contract which entitles it to receive similar future assets.

The general validity of these suggestions and their various implications need to be considered by experts, along with the many other complex issues involving derivatives and their interaction with Islamic financing. The debate cannot be initiated soon enough as the complexity and importance of the issues are certain to ensure its long-running nature.

Notes

1. We would like to acknowledge the contributions and technical support of Mr Tarikullah Khan and others in the Research Division of the Islamic Research and Training Institute (IRTI) in helping to formulate the arguments in this chapter.

2. It is worth mentioning here that some of the founders of Islamic banks have agreed on the establishment of an international organization under the name 'International Association of Islamic Banks' (IAIB). The objects for which the IAIB has been established are to promote, advise, support and represent the Islamic banks and foster co-operation at a national and international level through all available means. However, IAIB has not been effective. In 1993, a new active executive committee was elected. This change may bear fruit in enhancing the desired co-operation among Islamic banks.

CHAPTER 8

Islamic Banking in Pakistan

This chapter reviews the efforts made so far for the Islamization of the financial system in Pakistan. It is divided into three sections: (i) an introduction, and description of the historical perspective of the Islamization process; (ii) an account of the steps taken for the Islamization of the financial system; and (iii) an appraisal of the present state of the financial system.

Introduction

The case of the Islamization of the economy of Pakistan provides an interesting subject for study. It was the first serious attempt in the Islamic world, coupled with sound theoretical background, to convert the whole financial system into an Islamic one. It is a far more data-rich experiment than a single Islamic bank functioning in a conventional environment, or the experiment of a dual, side-by-side system of Islamic and conventional banking, as in Malaysia. Prior to any appraisal of the Islamic banking system in Pakistan, it is essential to assess and evaluate the environment in which the system is functioning, focusing on the political and economic environment of the country during the period of implementation.

The political environment in Pakistan during the period when the Islamic banking system was applied can be described as extremely unstable both for the economy and for Islamic banking. After the ousting of the Pakistan Peoples Party (PPP) in 1977, the country was ruled under some form of martial law by General Zia-ul Haq until his death in 1984/85. During that period, Islamic banking received a great boost. There were extensive activities in theoretical preparation of the Islamization of Pakistan, especially from an economic perspective. With the death of General Zia-ul Haq, the Junejo government took over in 1985. For the next three years, this government continued to implement the general economic policies of the previous era, with little enthusiasm for Islamic banking. Then Pakistan witnessed its second PPP era, followed briefly by the Muslim League era, which languished later into a period of acute political instability. Due mainly to this acute instability, the country lacked clear consensus concerning economic policies, including

Islamic banking. As a result, Islamic banking was neither adopted nor institutionalized, or supported.

Islamic banking was officially introduced during General Zia-ul-Haq's era, when the economic objectives were to shift the economy towards more private-sector participation in order to counter the effect of the programme of socialist transformation adopted by the previous government. Islamic banking was one of the tools used to increase private-sector involvement and encourage capital-risk participation. This led to the expansion of the private sector and unsustainable economic growth.

The economic performance in Pakistan has lacked reliable leadership. During the previous 20 years the economy has behaved like a roller-coaster. The GDP grew at an average rate of 6 per cent in the last decade whilst exports grew at an average rate of 16 per cent. Inflation has fluctuated between 4 per cent and 12 per cent, but the average annual rate was around 6 per cent. Pakistan's economy did not have the ingredients of sustainable economic growth due to the many inherited structural problems. Unless such problems are settled, it is difficult to envisage long-term, self-sustained growth (Iqbal, 1989). These problems include, among others: a huge budget deficit, heavy reliance upon the foreign sector; low savings; and balance-of-payment difficulties.

On the other hand, the performance of the private sector over the same decade has been quite resilient and impressive in its growth. Such growth is expected to increase further due to the positive response to privatization activities and the increase in the equity market. In the last four years, the economy has shown a mixed performance with an accelerated growth rate of 7.7 per cent, 2.3 per cent and 4 per cent for the years 1991-92, 1992-93 and 1993-94 respectively. Furthermore, inflation was high, reaching 9.6 per cent, 9.3 per cent and 11.2 per cent for the years 1991-92, 1992-93 and 1993-94 respectively. The country's foreign-exchange reserves improved significantly and reached US\$2.31 billion in June 1994, up from US\$1.012 billion in 1991-92. It is expected that the implementation of fiscal and monetary discipline, coupled with recovery in most sectors and adequate maintenance of law and order, will ease inflationary pressure and lead to sustainable GDP growth. One of the encouraging recent signs has been the significant increase in the rate of gross national savings from 13.6 per cent of GDP in 1992-93 to 15.4 per cent in 1992-94. This is further supported by the growth in bank deposits which averaged 20 per cent from 1992-95.

The financial system of Pakistan is made up of well-structured financial institutions such as commercial, co-operative and specialized banks. At the end of June 1994, there were 21 domestic and 20 foreign banks operating in the country, with total assets of US\$55 billion at the end of 1993. There are 11 specialized financial institutions, corporations and funds, including the Pakistan National Investment Trust (PNIT), the House Building Finance

Corporation (HBFC) and the Investment Corporation of Pakistan (ICP). The banking system is, however, characterized by over-regulation by the state bank and other regulatory entities, the predominance of the public sector and inefficient credit allocation as a result of administrative directives.

Process

The elimination of interest, which was the major part of the Islamization process, was boosted by the involvement of the Council of Islamic Ideology (CII). The council was asked to prepare a blueprint for an interest-free economic system in the light of Islamic teaching (Ahmad, 1994). A panel of fifteen experts, appointed by the CII, submitted its report in February 1980 and its recommendations, after extensive discussion and modifications, were incorporated by the CII in its final report in June 1980.

In its report, the CII suggested a three-year plan for the elimination of interest. In phase 1 of the plan, interest was to be eliminated, from July 1980, from all specialized institutions (such as HBFC). In the second phase, effective from July 1981, interest was to be eliminated from bank operations, financial institutions and other domestic financial transactions. During this phase, all national banks were to maintain a parallel system of PLS deposits, side by side with conventional accounts. In the third phase, effective from July 1985, banks were not to accept any deposit based on interest. Such a gradual approach was adopted because the CII recognized the difficulties that could arise in transferring wholly to a PLS system without adequate institutional arrangement or supportive environment.

The implementation of the Islamization process was a mixed one. The specialized institutions, which were the pioneers in the conversion to Islamic-based modes, had transformed all their operations by the end of 1981. This included the PNIT, ICP and HBFC, some of which managed to convert their operations earlier. PLS accounts were introduced in 1981, side by side with the conventional accounts. Banks were required to maintain separate arrangements for PLS accounts, including their investments, return and accounting system. By July 1982, banks were allowed to utilize other Islamic modes of financing, such as working capital, leasing and hire-purchasing. They were free to negotiate a management fee and profit-sharing ratio. In 1985, the parallel system of Islamic and conventional banking was terminated. All new deposits had to be on a non-interest basis. Furthermore, all financing provided should be based on permissible modes of financing as outlined in Circular No. 36 (dated 12 October 1982) of the State Bank of Pakistan (SBP). This included finance by lending (loans with service charge and loans with no return), trade-related modes (mark-up, mark-down, buy-back leasing, hire purchase, development charge) and investment-related modes (*musharakah*, equity, *murabahah* certificates and rent-sharing).

During the three years 1991-94, PLS deposits rose an average of 10.6 per

cent and reached a level of RS315.8 billion at the end of June 1994. Rates are decided by applying different weights prescribed by the state bank to different PLS deposits, PLS borrowings and equity. Banks have flexibility to set deposit rates of return based on their level of profits; however, profits were declared on a half-yearly basis. Deposit rates were described as low, compared to other modes, due to escalating expenditure, mandatory credit allocation and subsidized rates of borrowing by the government (SBP, 1992-93: 75).

The Islamization process took an historical step forward with the ruling of the Federal *Shari'ah* Court (FSC). The FSC disposed of 115 petitions challenging the legality of interest in 20 fiscal laws besides three *suo moto Shari'ah* notices. The FSC was mandated to admit petitions challenging fiscal laws on 25 June, 1990, before which date fiscal laws were out of its jurisdiction. The Government of Pakistan, by making successive amendments to the constitution, had kept these laws out of the jurisdiction of the FSC for over ten years. The FSC admitted the first petition challenging interest on 11 December, 1990, after which a number of other petitions was filed. The FSC announced its historic judgement in December 1991 on the legality of interest on financial transactions. It decreed that the provisions of interest in a number of fiscal laws come under the definition of *riba* and thus these legal provisions were repugnant to the *Shari'ah*. It fixed 30 June 1992 as the day when this decision would come into effect, after which these legal provisions would be null and void (FSC, 1992). This ruling put pressure on the Pakistan Government to take appropriate action by that date to amend or substitute these laws in the light of the *Shari'ah*. In the absence of practical solutions to replace interest, particularly from state transactions, the government had to resort to filing a successful appeal in the Supreme Court to obtain a stay order on the ruling of the FSC.

Appraisal

Pakistan embarked on a process of Islamization of its financial system in 1979. Though the system has undergone significant changes since then, the process of Islamization is yet to run its full course. At this juncture it does look as if the government has eliminated interest from the economy except for government sectors and international transactions. In reality, however, as many scholars argue, the change has been nominal, not substantial (Iqbal, 1989). The main concern for banks in Pakistan, as of other Islamic banks outside the country, is their asset concentration. Most Islamic banks shy away from PLS-related investment and engage predominantly in mark-up related transactions. This is what happened in Pakistan: mark-up activities, representing 90 per cent of the banks' financial transactions, dominated the system rather than being used as a transitional mode of financing as had originally been envisaged. The shift in asset allocation toward medium-and long-term investment and equity participation may require further structural

changes, including adequate institutional capacity and structure, the training of staff, adequate legal systems and enforcement.

Another concern is the *Shari'ah* transparency of the current practice of Islamic modes. The CII gave qualified approval to certain methods, such as hire purchase, while cautioning that this could open a back door to interest (Ahmad, 1994). In reality, the caution was not enough. The way mark-up is used by the Pakistani banks makes it very like interest and quite contrary to the concept of *bai' mu'ajjal*, which is what the CII had recommended. In addition, the banks have combined disjointed modes of financing and created an instrument where banks are practising buy-back and mark-up. Some scholars are worried that the mass use of some modes of financing, such as buy-back arrangements without *Shari'ah* scrutiny, could lead to faulty use of these modes. Despite the dominance of such modes, there are doubts about their compatibility with *Shari'ah*.

A third concern is the seriousness with which the process is being implemented. The government's relaxation of certain rules, such as allowing banks to treat the return from interest-bearing transactions as income, has encouraged banks not to maintain the momentum for change. Furthermore, schemes such as the rent-sharing of the HBFC, have, after many modifications, have become merely an interest-bearing arrangement. In addition, the government has allowed banks to invest the PLS deposits in interest-bearing government securities. Many financial transactions have been subject to extensive modification after implementation, which deflect these transactions from the prescribed *Shari'ah* rules. This calls for continuous *Shari'ah* scrutiny of the procedures in operation and control of the banks, including the state bank.

A fourth concern is Islamization of the government's own borrowing. No concrete steps have been taken to eliminate *riba* from the government's financial dealings, but to do so is essential, as the government is the prime actor in the credit market with a debt four times that of the private sector and a borrowing-rate three times. Many scholars have felt that the resolution of such issues is central to further evolution of the process (Iqbal and Mirakhor, 1987). Nevertheless, we have to bear in mind that creating instruments for public financing was bound to prove an Herculean task. Up to now, no efficient Islamic alternatives are available to allow states to mobilize the same resources currently arranged through conventional techniques. Of course we recognize that the government has avoided taking the necessary steps to implement change since these would require comprehensive budgetary reform with major political consequences.

The measures adopted for the Islamization of the financial system have also been characterized by a number of qualitative deficiencies, to the extent that a panel of experts felt that the process was 'put in reverse gear' (Iqbal, 1989) or lost its sense of direction (Ahmad, 1994). The deficiencies and shortcomings of the steps taken have been widely discussed in the country in recent years. It

is felt that lack of political commitment and inadequate institutional support since 1985 have led to the loss of momentum for change.

The process of Islamization has faced many difficulties. The first is the non-availability of Islamic instruments to finance public debt, a serious problem that all contemporary Muslim countries have to face in the process of Islamizing their economies. Though the Pakistani experience is a well-developed one, it has been unable to create sufficient Islamic financing instruments to cater for the financial needs of the public sector.

The second difficulty in Pakistan is how to deal with the external debt which is in the range of US\$20 billion. (External debt accounts for 35 per cent of the overall national deficit.) Such debt, half of which is bilateral while the rest is due to multilateral agencies, poses a great problem for the government. Though certain arrangements acceptable to *Shari'ah* could be reached on a bilateral basis, interest-free repayment arrangements are difficult to reach with multilateral agencies. One way of overcoming the problem is to reduce the need for interest-related credit by encouraging equity and privatization instruments, such as contracting-out or BOT (build, operate and transfer). Another way is to encourage Islamic financing from abroad, especially through Islamic banks. In Pakistan's US\$1.89 billion Hub River project, Islamic banks provided most of the financing in 1993. In addition, a US\$250 million facility was provided to the Pakistan Water and Power Development Authority (WAPDA) by a consortium of Islamic banks and the Islamic Development Bank. It will be a challenge to Pakistan to reach an understanding concerning foreign debt without jeopardizing the country's relationships with its creditors.

The third difficulty, brought to a head by the FSC ruling, is related to interest already accrued on loans. The bottom line of the FSC judgement was that interest is repugnant to the *Shari'ah* and should not be recognized. Big businessmen who had borrowed huge amounts of money over long periods and owed millions of rupees in interest wanted to seize this opportunity to get rid of their liabilities and pay only the principal they had borrowed, say 20 years ago, and whose present worth was not even 5 per cent of the original sum, given double-digit inflation. This had serious financial implications for the government and no solution could be found.

A fourth difficulty is how to develop sufficient practical Islamic financial instruments to cater for economic growth, including the secondary market. The Pakistani experiment with Islamization was active in the area of developing financial instruments, such as the solidarity bonds issued by Islamic insurance companies and participating-term certificates. One of the distinctive achievements was the introduction of the *muḍārabah* technique in June 1980. The inaction of the law and its subsequent regulations have helped such techniques to flourish, with necessary safeguards for certificate holders in the form of protective clauses. Under *muḍārabah* management, a company must contribute 10 per cent of the required capital to ensure risk-sharing and

its commitment to the success of the *muḍārabah*. Such techniques have become widely popular over the period 1992–95 and the number of *muḍārib* companies listed on the stock exchange in 1994 reached sixty. In addition, leasing has been boosted in Pakistan and many leasing companies established. However, some experts in *Shari'ah* consider a financing lease to be incompatible with the *Shari'ah* (Ahmad, 1994). We should note that most of these instruments were only traded locally due to the absence of an international market and inadequate institutional support.

The fifth difficulty is how to establish business ethics compatible with Islamic values. Prior to Islamization, the CII suggested certain requirements that had to be met, including: widespread teaching of Islamic values (or moral reform); reform of the tax system; reduction of unethical practices; and alleviation of illiteracy. One of the ingredients for successful Islamic banking, especially in Pakistan, is a properly enforceable legal system, with standard formats and contracts. Precise legal definition of the various modes of financing, with necessary protection clauses, is also essential. The inadequacy of the current system, for example companies ordinance and banking laws, does not encourage essential Islamic modes of financing, such as *mushārahah*, to flourish. A fair and enforceable tax system is also required. However, there are major considerations that are related to the prevailing value system. One challenge in that area is honesty and the practice of Islam as a way of life. Another is the fulfilling by a Muslim of his obligations to others. Since charging interest for late payment is forbidden, many Muslim borrowers try to exploit the opportunity this gives them, even though doing so contradicts their value system. To resolve such issues, 12 banking tribunals have been established in Pakistan, with the power to impose fines for late payment. They deliver their decisions within a period not exceeding four months.

A sixth difficulty is how to institutionalize the process through the SBP and avoid a fluctuating political commitment. It is a fact that the transformation of Pakistan's economy into a non-interest based system has not weakened the effectiveness of monetary policies and regulatory control (Iqbal and Mirakhor, 1987). The SBP continues to be in control, mainly through direct credit allocations and by controlling the rate of profit. The role of the SBP in the effectiveness of the Islamization process cannot be over-emphasized. Its tight control and follow-up of banks are major conditions for the process flourishing. If the SBP could give the right leadership by strict implementation of banking regulations and controls, by narrowing the deficit and strengthening the weak financial structure, it could have an even greater impact. However, many scholars have felt that the passive attitude of the SBP has made the Banking Tribunal Ordinance of 1984, and subsequent directives, ineffective. It is hoped that the February 1994 amendment of the SBP Act of 1956, which enhanced the bank's autonomy and power, will also enhance its role in the effectiveness of Islamization.

Summary and conclusion

Pakistan's attempt to Islamize its banking system is an interesting experience, and a well-respected one. It adopted a gradual approach with adequate theoretical background. Such step-by-step changes were generally accepted and did not create any fiscal, monetary and regulatory problems. The implementation of the process was done without major disturbance to existing banking operations. Further transformation of the system may, however require, besides restoration of political will, more *Shari'ah* transparency of the implementation process and a wider range of financial products. In addition, more structural changes are needed than has been the case up to now. The shift toward equity participation and medium-and long-term lending require such a change, including:

- changing the attitudes of the banks toward these modes;
- reforming accounting principles and their procedures to reflect accurately the profit level;
- installing adequate legal systems with enforceability and speedy settlement of disputes;
- providing means for secondary-market growth; and
- the reorienting and training bank staff.

The Islamic banking experience in Pakistan is a modest one with many deficiencies, and taking a further step will require a clear political commitment, major legal reform and adequate institutional capacity. The installation of an Islamic value system, without which the process will certainly remain in the muddling-through stage, is vital. Finally, unless government borrowing is shifted to a non-interest basis, it is difficult to envisage any further progress in the Islamization process.

Comparative Analysis of the Financial Statements of Islamic and non-Islamic Banks

The financial statement of any financial institution or bank represents in numerical form its assets and liabilities at a certain date. It also states, again in numerical form, the revenues and expenditures of the institution, that is, its balance of income. The financial statement is also an income statement. The presentation of such information is essential to rational investment decisions and therefore needs to provide an acceptable level of transparency.

The way financial statements are presented is becoming standardized, and the standard form is well-recognized all over the world. The Islamic banks are no exception. Except for minor details, which will be explained later, Islamic banks try to follow international accounting standards. Nevertheless, the balance sheet of the Islamic banks, due to the nature of their business, requires, in a few cases, a different interpretation than that of its counterpart in conventional banks. This is mainly in the area of revenue recognition and profit-sharing with depositors (Banaga, 1994). Such a difference is an added burden for the external auditors of Islamic banks. For example, the *Shari'ah* requirement (mainly prohibition of interest) and the lack of approved accounting standards for Islamic banks are additional responsibilities for the auditors. External auditors should, therefore, have a wider coverage in their audit functions, with more detailed notes and explanations in their report.

In order to standardize the presentation of the balance sheet of Islamic banks and to inspire confidence in their users, a non-governmental body called the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) was established in 1989.¹ The AAOIFI, which is based in Bahrain, has set out standards in a number of areas, including general presentation and disclosure for banks and other financial institutions, but the activities of the AAOIFI have yet to run their course. There is still a need for more publications and dissemination of information in this area, as well as for wider recognition of AAOIFI standards and procedures by national and international regulatory bodies.

Differences between Islamic and conventional banks

Due to the nature of their operation, there are a great many differences between Islamic banks and their counterpart, conventional banks. These are

Table 9.1: *Risks faced by Islamic and conventional banks*

	Conventional commercial bank	Islamic bank
Credit risk	A	A (high)
Maturity mismatch	A	A (high)
Currency risk	A	A
Interest-rate risk	A	N/A
Risk of trade and investment transactions	N/A	A
Liquidity risk	A	A (high)

A: Applicable

N/A: Not Applicable

mainly in the *Shari'ah* requirement and the economic substance of the Islamic banks' activities. In this section we will be focusing on only a few areas which we feel are essential for the readers of the financial statements of Islamic banks.

One difference that warrants consideration is that the Islamic banks do face a risk not faced by their conventional counterparts. Though both have to take credit risks, capital adequacy, liabilities and asset-matching risks, currency-fluctuation and liquidity risks, the risk for the Islamic banks is higher, due to their extensive trade and investment activities. Table 9.1 summarizes the different kinds of risks that any bank may face.

The maturity-mismatch and liquidity risks in Islamic banks arise from the lack of sufficient *Shari'ah*-based liquidity instruments. The mismatch risk is increased due to the fact that Islamic banks go for longer in their investment and operations without an adequate redemption facility. Nevertheless, some risks to which conventional banks are subject do not exist in Islamic banks, for example, interest-rate risk, since interest is prohibited in their operations.

Another difference lies in the focus of financial-accounting information. While in conventional banks the emphasis is on interest-rate spread, provision of loan portfolios and maturities of the liabilities, in Islamic banks it is on asset allocation, and return from investment and trade. (Both, however, emphasize liquidity, quality of assets and transaction costs.)

A third distinctive difference is the under-capitalization of most Islamic banks. In order to illustrate these points, we have made a comparative analysis between three banks, two conventional and one Islamic, all operating in the same country (see Table 9.2).

The under-capitalization of the Islamic bank is clear from Table 9.2, where its equity-to-asset ratio is shown as 5.11 per cent, or half of the average of all banks which is 10.69 per cent.

A fourth difference is the huge liquidity of the Islamic banks. Table 9.2 shows that liquid assets in Islamic banks are almost double that of their

Table 9.2: *Comparison of selected financial ratios for Islamic and conventional banks*

	Bank (1) (%)	Bank (2) (%)	Islamic bank (%)	Average of all banks (%)
Return on assets	1.59	1.43	1.08	1.12
Return on Equity	15.87	12.01	24.37	11.15
Liquid asset to asset	27.59	30.18	52.42	24.14
Liquid assets to deposits	32.08	35.55	60.39	28.25
Equity to asset	9.97	12.03	5.11	10.69

Note: This comparison was done in 1993 for three banks in the State of Kuwait: (1) the National Bank of Kuwait, (2) the Gulf Bank, and the Kuwait Finance House.

counterparts. Liquid asset-to-asset ratio is 52.42 per cent for the Islamic bank while the average for the banking industry is 24.14 per cent. This is attributed to the lack of sufficient liquidity instruments, the absence of suitable investments and products with adequate redemption facilities. Such high liquidity is also attributed to the non-existence of a secondary market for Islamic instruments. But Islamic banks also maintain such high liquidity because they cannot use central banks as lender of last resort due to the incompatibility between the two institutions.

A final difference between conventional and Islamic banks is the *Shari'ah* requirement of the latter, which must comply with the principles and rules of the *Shari'ah* in all financial transactions and operations.

Comparative analysis

A comparative analysis of the financial statements of an Islamic bank and a conventional bank reveals that there are similarities in some areas while in others there are differences. Both have an identical component of shareholders' equity. Both have cash and liquid assets; in Islamic banks, however, these are mainly cash assets contrary to the practice of conventional banks which maintain such instruments as treasury bills. Both also have fixed assets and other liabilities; their components differ, however.

To illustrate these differences and their respective weights, a comparative analysis of an Islamic bank and a conventional bank was prepared. The results are presented in Table 9.3.

From Table 9.3, we can see that the Islamic banks are allowed to invest in trade transactions and real-estate operations while conventional banks are not. On the asset side of conventional banks, loans represent a substantial proportion, whereas in Islamic banks such a component rarely exists; if it does it will be marginal and free from interest. The major portion of the asset side of Islamic banks is made up instead of receivables, such as *murabahah* and leasing transactions.

Table 9.3: *Components of financial statements and weight in one Islamic bank compared to a conventional bank (%)*

Islamic bank		Conventional bank	
<i>Asset</i>		<i>Asset</i>	
Liquid assets	25	Liquid asset (including treasury note, T-bill)	21
Receivables (<i>murābahah</i> and others)	35	Investment & deposit	23
Investment, including real estate	24	Loans	52
Fixed & other assets	16	Fixed & other assets	4
<i>Liabilities & equity</i>		<i>Liabilities & equity</i>	
Current & investment accounts	78	Deposits	90
Deposits	14		
Other liabilities	2	Borrowing & other liabilities	0.5
Depositors share of profit	2		
Shareholders' equity	4	Shareholders' equity	9

In the income statements of conventional banks, one can find interest income/expenses which represent a substantial part of the statement. In Islamic banks, again such components do not exist. They are replaced by income from *mudārabah*, and trade and leasing operations. If there is a gain generated from operations prohibited by *Shari'ah*, such income will not be recognized in the statement as income. Furthermore, the profits of the conventional banks are declared after deducting interest expenses payable to depositors, but in most Islamic banks profits declared will be profits before deductions to pay the depositor's share of those profits. This results from the fact that depositors in Islamic banks share the profit and loss of the bank which is not the case in conventional banks.

Beyond the balance sheet

Due to the particular nature of Islamic banking operations, a number of considerations needs to be understood and kept in mind while scrutinizing the financial statements of Islamic banks. The most important of these are:

- The extent to which an Islamic bank is under the authority and jurisdiction of the central bank and what powers the central bank has, under the law, to control, maintain and support it.
- The difference in some basic accounting policies. Some Islamic banks deduct all expenditures (indirect as well as direct) from their profits, others deduct only the direct expenditures. Also, when some banks declare their profit, it includes the corporate profit and the profit that will be distributed to depositors as return to their deposits.

- The relationship between Islamic banks and their clients is based on profit-and-loss-sharing between the depositors who provide the fund and the Islamic banks which provide the investment effort. There is no guarantee for the principal, or a prescribed return. Since their deposits are managed on a profit-loss basis, clients have an interest in understanding and evaluating the bank's ability as investor and its rights and obligations. This necessitates adequate disclosure, mainly with respect to an appropriate level of separation of financial data and detailed explanatory notes on items pertinent to the nature of Islamic banks.

Notes

1. Previously Financial Accounting Organization for Islamic Banks and Financial Institutions.

CHAPTER 10

The Challenges Faced by Islamic Banks

Many challenges and obstacles that face Islamic banks have already been identified and analysed. These challenges have arisen mainly from the lack of a supportive environment, inadequate regulation and the infant stage of Islamic banking. In this chapter we would like to emphasize the major challenges which are common to Islamic banks. We do not address here the challenges facing Islamic banks in countries which have adopted an Islamic banking system, such as Iran, Sudan and Pakistan. This is because these challenges are transitional and relate to macro-economic factors. Though there are many operational and other problems related to specific regions or banks, our emphasis here is on the general challenges that face the Islamic banking movement.

Conventional banks and Islamic banking

Many Islamic banks or individuals in the Islamic world wonder how their conventional counterparts structure their so-called Islamic transactions or Islamic investment units. Many conventional banks have been interested and active in Islamic banking since the early 1970s. Institutions such as ANZ Grindlays, Citibank, the Union Bank of Switzerland, Credit Swiss First-Boston and Kleinworth Benson have been very active in conducting *murābahah* transactions, leasing and other investment instruments for the last 15 years. Japanese banks have followed the same path: the Industrial Bank of Japan (IBJ) has established an Islamic portfolio for *mudārib*. Arab conventional banks have also followed suit, such as the Arab Banking Corporation, Gulf International Bank, Saudi International Bank and the United Bank of Kuwait. Such activities in Islamic transactions may create suspicion among many individuals and institutions in the Islamic world about the conformity of such transactions to *Shari'ah*. The *Shari'ah* constitution does not prevent Islamic banks from conducting transactions with conventional banks provided that the conventional banks follow the rules of *Shari'ah* and structure their instruments or transactions accordingly. These conventional institutions should be encouraged and supported in such endeavours since they have the knowledge and experience to enrich the Islamic banking. They could introduce viable investment opportunities due to their large market and

accumulated expertise. The entrance of such institutions increases competition, provides broader diversification of markets and risks, and better liquidity arrangements. It also allows wider interaction between conventional and Islamic systems which will facilitate better understanding for both and lead to the globalization of financial markets.

Of course it can be argued that the entrance of such banks, especially from the West, will attract funds at a cheap rate from developing countries and channel these into the developed world, later recirculating them at a higher rate. This will lower the flow of resources and increase the cost of essential resources to these countries and reduce the utilization of their indigenous means. This argument is rational and justified, but it is difficult to restrict the supply and movement of resources while their utilization is not improved. The emphasis should be on how to improve the investment environment in Islamic countries in order to keep such resources in those countries. Furthermore, this and similar arguments put forward by some Islamic banks are not adhered to by Islamic banks themselves: many invest their surplus or liquid funds with conventional banks and institutions in the West in investments according to *Shari'ah* principles.

In our opinion, Islamic banks could play the role of financial intermediaries in attracting funds from the Western hemisphere. Because of the potential purity of their system, the reduced moral hazard and hopefully their good investments, Islamic banks could act as mediators of funds to Muslim countries.

There is considerable scope for interaction and collaboration between Islamic banks and their conventional counterparts. The Hub River project in Pakistan and the Petrochemical Project in Kuwait are examples of how combined- and parallel-financing, while structured separately, can come together to fulfil the funding needs of a large project.

In summary, the entrance of conventional banks into the Islamic banking business, assuming and provided their transactions conform to *Shari'ah* rules, should broaden the acceptability of Islamic transactions as well as their coverage and scope, and improve the efficiency of Islamic banking by increasing competition.

Central banks and supervision

Many central banks in regions where Islamic banks are functioning do not have the legislation or the tools and procedures needed to supervise those Islamic banks. Lack of understanding and experience of Islamic-bank transactions, as well as the lack of regulations, make it difficult for central banks to adapt to the structures and procedures used in Islamic banks. The consequent resentment and tension in their relationship tends to make central banks less understanding of, therefore less willing to support, Islamic banks. But the situation is changing. Recently many central banks have accepted the concept

of Islamic banking and are seriously considering specific laws and regulations to oversee this growing market. In some countries, notably Turkey, Jordan and Malaysia, specific laws for the establishment of Islamic banks have already been issued. In other countries, the regulatory authorities are becoming increasingly determined to exercise greater control over Islamic banks, especially over the liquidity ratio and reserve with the central bank. In general, more central banks are willing to extend support and supervisory control to the operation of Islamic banks than previously.

One area of misunderstanding between central banks and Islamic banks is over the protection of depositors. The regulations of many central banks provide tools for the protection of depositors, a practice which is in contradiction with the concept of PLS deposits of Islamic banks. In Britain, Denmark and even in many Muslim countries, the protection of depositors is an essential requirement for granting a deposit-taking licence. The Bank of England, as banking supervisor, has to ensure that its banking facilities offered in England are in accordance with the national legislation. This means working with the Islamic banking community to resolve any problems over the capital-certainty of funds placed with an Islamic institution.

In any efforts to establish financial products according to *Shari'ah* and to ensure the institutional framework necessary for the smooth operation of such banks, the role of central banks is critical, even essential, for success (Mirakhor, 1988). For example, Bank Negera Malaysia established guidelines in the Islamic Interbank Money Market (IIMM), which were introduced on 3 January 1994, designed to integrate Islamic financial instruments throughout the banking system in Malaysia; as well as the one wholly Islamic bank, no less than 20 conventional banks opened Islamic banking counters in order to benefit from this scheme.

Shari'ah rulings and councils

Many bankers, and institutions, who interact with Islamic banks are often easily confused by the different rulings of the *Shari'ah* councils. Individual transactions or instruments are approved or disapproved and then later the ruling is changed. This is because the issues are still in the pilot stage and new circumstances or arguments come to light which lead to alteration of the ruling. Take the difference on the allowance of equity-holding or stock in companies that do not deal with prohibited commodities or activities but have financial relations with banks on a conventional basis. Most scholars do not allow investment in such transactions while others find them acceptable. Such differences of opinion are bound to create confusion in the minds of conventional bankers or institutions about the conformity of such transactions to *Shari'ah* law. There are also differences about what is specifically permitted within contracts which are generally allowed, for example, *murabahah* contracts are widely accepted, but some *Shari'ah* councils apply particular

restrictions to the contract which others do not. Again, even where the concept and structure of transactions are similar and permitted, the details of how the transactions will be conducted may give rise to differences about permissibility. For example, two kinds of contracts can be found for leasing ships, one accepted by the *Shari'ah*, the other rejected – most likely on account of minor details or differences in underwriting arrangements.

What leads to such differences in ruling is the absence of a well-established forum where *Shari'ah* scholars and councils who follow different schools can get together and form a consensus about reasoning procedures and particular issues. The Fiqh Academy of the OIC should provide such a forum, but its (perceived) narrow representation means that not all Islamic banks accept its rulings.

The lack of consensus among *Shari'ah* councils is a difficulty for Islamic banks since it creates unnecessary confusion and so restricts the concept of Islamic banking from wider acceptance and recognition. Such consensus could be reached by establishing a better balanced and more widely representative forum for dialogue; it could be enhanced by: establishing an acceptable code of rules and procedures; standard contracts; improving the R&D capacity of Islamic banks and institutions; and by encouraging *Shari'ah* scholars to widen their exposure to, and knowledge of, modern banking practices.

New banking regulations

Many banking regulations which are crafted to fulfil the control requirements of conventional banks pose difficulties for Islamic banks. Though such rules prevail more in non-Islamic countries, regulating authorities in Islamic banks in those countries do follow suit. Most of the time, however, the philosophical concept and the structure of Islamic banks do not go well with such regulations. Though Islamic banks in both Western and Islamic countries face different challenges with regard to adherence to regulations, both find it difficult to interact or reach an understanding with the regulatory bodies in the absence of a body of appropriate rules to regulate Islamic banking.

One area of uncertainty is whether the jurisdiction over Islamic banking falls to the civil law courts or to the *Shari'ah* court. There is need for a well-defined legal system which integrates the existing banking system and *Shari'ah* law. This could include reorienting the property-rights system and contracts recognized by civil and corporate law to accommodate Islamic-based contracts and modes of financing.

It is said that the Basel Committee requirement for minimum capital adequacy is another example of the regulatory challenge that is facing Islamic banks. It overestimates the risks to assets. Since most Islamic banks' investments are in Muslim countries, most of the banks will continue to fall below the required capital-adequacy level. However, in theory, when a British bank lends to a small *souq* trader in Dubai, the capital weighing is exactly the same as when it lends to a major company like Shell in the UK.

However, many Islamic banks have been able to cope with such emerging bank regulations even in a non-Muslim environment. The Faisal Islamic Bank International (FIBI), based in Copenhagen, is one example. It is registered under the Danish Banking Supervision Board, and, since January 1993, has been subject to various EC banking and financial directives.

Regulatory agencies cannot be blamed for over-regulating or over-reacting to uncertainty. In the absence of clear, clearly-understood rules of the game, regulations should be applied conservatively and prudently. Regulators should, however, acquaint themselves more with the concept and structure of Islamic banking. When feasible regulations and control of Islamic banks should be established by central banks or other regulatory bodies.

Accounting principles and procedures

Due to the fact that the balance sheet of an Islamic bank and the nature of the items on it have a different interpretation and impact than those of conventional banks, there is a need to understand the financial statement from its own perspective. That alone may not suffice, however, to enable reliable decisions to be made if the statement does not present information fairly, in a way that can be understood by all interested parties. It seems from the past experiences of many accounting firms in auditing the accounts of Islamic banks that certain accounting difficulties had developed, especially in matters of revenue recognition and profit-sharing with depositors (Banaga, 1994). This was due to a lack of accounting standards specific to Islamic banks (see Chapter 9). In 1989, Islamic banks established an accounting standard for Islamic banks to cater for such needs. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), from its base in Bahrain, has published several standards, such as:

- Objectives of Financial Accounting for Islamic Banks and Financial Institutions.
- Concepts of Financial Accounting for Islamic Banks and Financial Institutions.
- General presentation and disclosure in the financial statements of Islamic Banks and Financial Institutions.

These standards will be effective from the end of 1995. From the experience of many auditing firms, it has become evident that the role of external auditors in supervising Islamic banks is different and wider than is the case for conventional banks (Banaga, 1994).

Absence of liquidity instruments

Many Islamic banks lack liquidity instruments, such as treasury bills and other marketable securities, which could be utilized either to cover liquidity shortages or to manage excess liquidity. This problem is aggravated since many

Islamic banks work under operational procedures different from those of the central banks; the resulting non-compatibility prevents the central banks from controlling or giving support to Islamic banks if a liquidity gap should occur. For example, FIBI operates 2-10 per cent of its balance sheet in the conventional banking system due to liquidity mismatch and the need for overnight facilities (Trolle-Schultz, 1986). The matter of liquidity management has come under active discussion and scrutiny in the last two years. Many technical committees have been established to evaluate the proposals presented by different banks concerning investment funds, commodities funds and liquidity management. Eventually, it was agreed to combine all three issues and to undertake a feasibility study on liquidity management of Islamic banks. This study is expected soon to be assigned to a reputable firm by the Islamic Banks Portfolio (IBP).

Medium-term investments and instruments

Early research on Islamic banking models envisaged that funds would be used mainly on *muḍārabah* and *mushārahah*, practices which are based on profit-sharing. However, due to the many risks (the short-term nature of the loan and uncertainty) and operational problems involved (obtaining adequate return relative to competitor banks), the banks now lean toward modes of financing which have less risk and involve a predetermined return on capital, such as *murābahah*, *bai' mu'ajjal* and *ijārah*. Though this is a deviation from what Islamic economists earlier anticipated (Nienhaus, 1986), it is a sign of the flexibility of the banks' operation and of their adaptability to changes in the environment. Due to the nature of their concept and operation, the banks are expected to have a longer investment duration and reduced short-term investment activities. Unless changes are made to the nature and structure of their current liabilities, however, it will be difficult for the banks to go for longer investment periods.

Many issues need to be resolved in order for Islamic financing to flourish. For example, financing a power station by means of leasing may lead to problems. The pre-construction and infrastructure works couldn't be financed unless the restriction on foreign ownership were amended. Similar difficulties apply to tax and VAT treatment under relevant local laws. In addition, during construction the ownership of the asset by the Islamic banks could affect contractual warranties and insurance policies, and sometimes the lessor is expected to grant a mortgage on the asset as a part of the security package, which many banks are hesitant to undertake.

The creation of an International Islamic Lease Financing Company was an appropriate step in facing the challenge of sound long-term projects. The aim of the company is to promote the leasing of equipment and machinery and the creation of assets which could form the basis of issuing papers for the secondary market. The holding company is envisaged progressively to create

specialized national leasing companies as its operating arm, while banks and other private investors act as an apex body and supplier of funds. The feasibility study for such a company is being finalized and the shareholders' list is about to be closed. The study will suggest the best avenues for setting up at least two specialized leasing companies at national level.

In addition, it is essential that the banks improve and enhance their capabilities in medium-term project financing such as equity and project investments, and at the same time improve instruments which may act as liquidity buffers.

As a result of the 1992 ruling of the Islamic Fiqh Academy which prohibited participation in the shares of joint-stock companies dealing in usury, Islamic banks considered a joint pilot project. The project will explore the possibility of substituting the interest-based financing of two existing companies with such financial instruments as are acceptable under the rules of the *Shari'ah*. Two successful companies were selected for this project, one from Egypt and the other from Pakistan. Extensive discussion is underway to provide the financing of these companies according to their operational needs.

In their efforts to enhance investment ability, the banks decided to establish the IBP. This is a joint fund created by the banks and IDB to participate in the development of trade and investment in countries in the Muslim world. Its capital of US\$80 million and it has a membership of 22 banks. Participating banks recently approved the raising of its capital to US\$300 million. At the same time it was granted credit from the IDB of US\$70 million for trade investments and US\$150 million for leasing operations.

Risk analysis and measurement

The present infancy of Islamic banks means that their risk analysis and risk measurement are not developed to the extent necessary. Risk analysis is very important in conventional banking operations and the central banks impose certain measures to ensure that the banks do not exceed an allowable risk. Though both conventional and Islamic banks share similar risks that need to be managed, such as credit and foreign-exchange risks, they differ in the level of such risk. Islamic banks expect to be active in equity and project financing and should expect to monitor investment risk carefully. Asset management and credit analysis are essential tools of their risk management since they do not utilize derivatives to minimize such risks, such instruments, for the present, being outside *Shari'ah* guidelines (see Chapter 7). The risk-exposure level needs also to be reduced through geographical and product diversification and pursuit of more activities off the balance sheet. At present, systematic risk analysis and measurement is not well-developed in Islamic banks, which may lead to a more riskier portfolio or, as we found in Chapter 7, to risk avoidance, which is partly why the banks do not enter into PLS transactions. On the other hand, we need to bear in mind that the nature of Islamic transactions requires a more liberal attitude toward risk.

The shift towards PLS required a procedural framework to be effective. This may increase transaction costs because of the additional processing, monitoring, supervising and auditing involved. However, such transaction costs may be offset by the expectation of higher profitability (Iqbal and Mirakhor, 1987).

The Islamic Trading Company (ITC) was established in Bahrain with authorized capital of US\$100 million and paid-up capital of US\$20 million. The company began its activities in May 1991, but its achievements have so far been modest. It was hoped that by mobilizing the resources of the banks such a company would act as a pool arranger and a major player in promoting trade among Muslim countries.

Honesty and moral responsibility in Islamic banking contracts and activities are indispensable ingredients of Islamic behaviour (Khan, 1987). In order for Islamic banks to flourish in the presence of moral hazards, some institutional and behavioural changes need to be introduced. Institutional changes would be those which prevent the non-disclosure of correct income, strengthen the audit system, enhance the banks' accounting standards and streamline the tax system and its collecting machinery. There is also need to implement a legal and institutional framework to facilitate contracts and to provide adequate information for both lender and investor, which would have the added benefit of reduced monitoring and transaction costs. As for behavioural changes – these are more the responsibility of the society as a whole than of the banks operating within it. There certainly needs to be an increase in ethical awareness, responsibility, self-discipline and self-restraint, an understanding that correct professional conduct is of benefit to everyone. A great deal could be done through concerted efforts by the education system and the mass media.

Lack of qualified professionals

Due to the recent emergence of Islamic banking and the lack of academic and professional training, Islamic banks suffer from a shortage of qualified managers in different areas of their operation. Though many conventional training courses and programmes could be utilized to upgrade their capabilities, the need for tailor-made training programmes cannot be over-emphasized. The Islamic banks recently agreed to collaborate with the Bahrain Institute for Banking and Financial Studies, attached to the Bahrain Monetary Agency, to cater for their training needs and to conduct basic training programmes.

The level of success the Islamic banks achieve will depend at the micro level on the quality of management and the level of staff training (see Chapter 8). In an effort to co-ordinate and upgrade their training activities, the banks decided, in 1992, to establish a Training Advisory Board, which is responsible for enhancing the training capacity of the banks and ensuring effective co-operation among them in this regard.

Many Islamic banks' staff also lack the *Shari'ah* knowledge to convey to customers or conventional bankers, and due to the shortage of qualified and committed Islamic bankers, many staff do not have the commitment required to implement the *Shari'ah* guidelines. This is aggravated by the fact that most staff come from conventional banks and are acquainted only with the conventional approach.

Product diversification and service quality

Many Islamic banks do not have the diversity of products essential to satisfy the growing needs of their clients, such as structured instruments for financing trade, leasing and money-market instruments. The importance of technology and information in upgrading the acceptability of a product and diversifying its application cannot be overemphasized. Many Islamic banks also lack the necessary expertise and institutional capacity for R & D which would allow them to develop the needed products, so it is not surprising that most depend on conventional banks in this regard.

In order to pool their resources in R & D, the banks decided, in 1992, to establish an Academic Research Co-ordination Bureau, which is hosted by the Saleh Kamel Center for Islamic Economics, Al-Azhar University in Cairo, Egypt. Its activities currently include reviewing the contracts of Islamic financing and banking control policies.

One of the conclusions of our survey, as indicated in Chapter 8, was that the survival and vitality of Islamic banks depend on the quality of their services and the satisfaction level of their clients. It was observed that the quality of services improves if there is competition from existing Islamic banks in the country. Since the conventional wisdom in quality services and successful marketing is highly developed, Islamic banks should make good use of such knowledge and experience.

Non-maturity of secondary market

In many areas Islamic banks are not competitive nor are they able to develop their operational base because of lack of a secondary market. However, many efforts have been made to develop such a market, such as, the IDB Unit Investment Fund, Al-Baraka Al-Amin and Al-Tewfik Unit Fund, the IBP, and many other funds that have been created recently. These funds have been very active for the last two years. It has, however, been difficult to establish such a market because of non-recognition of such funds in many stock markets and the confinement of their marketing activities to a certain sector or population. An important step in this direction was the approval by the Turkish Capital Market Board of a new instrument for PLS investment. The Special Finance Houses in Turkey are therefore able to offer such PLS certificates to the public and to create a secondary market for them.

Cost-effectiveness

Current competition in the global market makes awareness of the cost-effectiveness of bank operations an essential requirement for the survival of Islamic banks. As competition increases, the spread and return will make the banks less competitive. They could subsequently lose their customer base. It is therefore necessary to have a very efficient costing system and implementation of appropriate advanced technology in order to compete in the global market.

Professionalism

The need to develop professional bankers or managers for Islamic banks cannot be overemphasized. Some banks are currently run by members of the owner's family or by direct involvement of the owner himself, or by managers who have not had much exposure to Islamic banking activities nor are conversant with conventional banking methods. Consequently, many Islamic banks are not able to face challenges and stiff competition. There is a need to institute professionalism in banking practice to enhance management capacity by competent bankers committed to their profession. The role of traditional and religious personalities in promoting Islamic banking is greatly to be admired and appreciated, but their traditional style of management hinders its growth.

Co-operation among Islamic banks

In light of the non-supportive environment in which they operate, Islamic banks have, focused on co-operation as a way to survive. One forum which was established to enhance cooperation is the International Association of Islamic Banks (IAIB), which was set up in 1977 to promote and foster the Islamic banking movement, and recognized by the Organisation of Islamic Conference (OIC) as one of its affiliate organs. However, it was not able to achieve its objectives due to lack of consensus and inefficient management. The recent reshuffle of the executive committee, coupled with the appointment of a dynamic secretary-general, should give a necessary boost and credibility to the association.

Due to the non-function of the IAIB, Islamic banks hold periodic meetings under the umbrella of the IDB to promote co-operation and consultation. These meetings are held at two levels: one at the level of directors of operations and investments, held twice a year, and the other at the level of heads of institutions, held once a year in conjunction with the annual meeting of the IDB board of governors. Many of the practical instruments for co-operation which now exist among Islamic banks, such as the IBP, joint financing and syndication, are the outcome of such meetings.

Social role and duty

Many researchers have anticipated and emphasized the social role of Islamic banks, namely that they should contribute positively to essential social needs, such as poverty alleviation, granting credit to the poor, donating to charities, and helping to achieve redistribution of income. Others have felt that the Islamic banks should put the emphasis on social considerations in training and in their operations, and play a more dynamic role in the achievement of socio-economic growth. Many banks have been trying to fulfil these expectations, but their efforts have been modest and fallen short of the level required. Furthermore, it is expected that as Islamic banks become established and profitable, more funds will be diverted and their activities reoriented to fulfil their social responsibilities and developmental role. To enhance their intervention in such areas, the banks should depend more on non-government organizations. This would involve highly motivated workers, operating economically with flexible decision-making, which would undoubtedly improve service efficiency.

After examining the challenges faced by Islamic banks, including the competition from commercial banks, we can now suggest the major issues to be considered before engaging in Islamic business and transactions, and this is the subject of our next chapter.

Important Considerations before Engaging in Islamic Transactions

Prior to undertaking any Islamic transaction, conventional banks need to be aware of the many steps involved and to give careful consideration to each of these. A few points especially need to be addressed. Though these do not necessarily represent a minimum for a successful endeavour in Islamic banking, they give the necessary basic ingredients:

A strategic objective, not a short-term deal

Many conventional banks have been successful in their undertaking of Islamic transactions because they pursue them from a strategic point of view and consider them as part of their overall corporate objectives. Unless Islamic transactions have a definite place within the strategy of the bank, the resources necessary to achieve this objective will not be directed toward promoting such business. Furthermore, building a relationship and conducting business with Islamic banks requires much effort and resources. This is attributed to the fact that such business is built on trust and confidence through personal relationships which usually take time to establish. Citibank, with its office in London, has formed extensive relationships and business with many Islamic banks, such as the Kuwait Finance House, because they directed many resources toward this end.

Targeting a niche/developing specific products

Experience shows that those banks who specialize in a niche in the market, or develop particular products in line with their own speciality, have been successful in attracting Islamic banking business. Examples of such niches in the market are leasing, commodity trading, currency funds, real-estate funds or venture capital. Conventional banks could also use Islamic banks for financing business projects in Islamic countries. Where the strategy for targeting the niche or developing the products was designed after careful study of the market by conventional banks with the necessary expertise and knowledge, the results were very successful. As Islamic banks still lack the modalities and instruments to finance the short-term liquidity and working-capital needs of companies, there is room for conventional bank expertise.

For example, the Faisal Islamic Bank, Bahrain (FIBB), arranged a US\$600 million syndication for Pakistan to finance commodities like rice and cotton with the co-operation of conventional banks, such as Grindlays and ABC International.

Integration of other bank services

Conducting business in an Islamic way or making business deals with Islamic banks need not mean being technologically backward. Most Islamic banks appreciate a combination of Islamic transactions with the advanced and specialized services available to conventional banks. For example, if an Islamic transaction is done through an electronic link provided by a conventional bank, this will only improve the attractiveness of the deal. Furthermore, Islamic banks expect to grant facilities whereby no interest is received on credit balances and no charges on the account when it is overdrawn.

A unit for Islamic banking

Many conventional banks only flirt with the idea of establishing a specialized unit for Islamic banking. Experience shows that such a unit creates more business for the conventional banks and can be a focal point for communication and enhanced relationship. Having such a unit is a means to accumulate relevant experience, and it increases trust in the viability and authenticity of Islamic transactions. This is mainly because a separate unit is assured of independence as an entity within the bank practising its own procedures pertaining to Islamic rules. However, the establishment of such a unit and the extent of its staffing would depend on its strategic viability, the amount of business expected and the cost-benefits of such a move. Such a unit needs to have sufficient flexibility to be able to react promptly to the need of its clients. Many banks, such as the United Bank of Kuwait, the Industrial Bank of Japan and the Arab Banking Corporation, have an Islamic banking units and have found them to be beneficial.

Staffing the Islamic banking unit

If conventional banks decide to establish an Islamic banking unit, the staffing of the unit should be considered very carefully. The staff should combine experience in state-of-the-art conventional banking transactions with an understanding of Islamic banking practices. Preference should be given to suitably qualified professionals from the Islamic region; this would help increase the trustworthiness of the unit in the eyes of clients and help in marketing the product. Staff should also have knowledge of financial restructuring or financial engineering as most of the work in the unit would comprise

the development of financial instruments which cater for the current needs of Islamic banks.

Islamic banks and monetary authorities

Before building up any contact with the Islamic banks, the relationship between the banks (the clients) and the central bank or monetary authority would need to be understood clearly and evaluated. Some countries, such as Pakistan, Iran and Sudan, have undergone wide Islamization of their banking system. Such a system should be evaluated in macro perspective as well as from the client's point of view. Some Islamic banks are outside the authority of the central banks and these are not expected to support them if the need arises, nor will they act as lender of last resort. Others, however, are under the authority of the central banks which are expected to render support if necessary, but there are differences within this group. In some countries such as Bahrain, Qatar and Saudi Arabia, others, such as Malaysia and Turkey, Islamic banks are supervised by special regulations. For example, the Bank Islam Malaysia (BIM) is under a regulation which has three components: the Islamic Banking Act, the Conventional Banking Act and the Central Banking Act. Other banks abide by the policies and directives of the central banks but supported by other entities such as the ministry of finance. This is the case with the Kuwait Finance House.

Client creditworthiness

Many Western institutions have difficulty in evaluating the creditworthiness or deciding the limits and exposure for Islamic banks. Due to a lack of relevant information and the narrow coverage of Islamic banks by credit-rating agencies, it is vital to gather as much information as possible before conducting any business.

Informal communication and fact-finding missions can be helpful in assessing the creditworthiness of a client. Some credit-rating agencies provide special reports about most Islamic banks, such as the Athens-based Capital Intelligence Credit Agency.

Since many Islamic banks are regulated or controlled by central banks, it may be advisable to consult with the national central bank about the record of the particular bank concerned. Careful consideration should also be given to the quality of management, creditworthiness of ownership, and operational efficiency. If the bank is part of a group, special attention should be given to inter-group business.

Shari'ah councils/advice

A main ingredient for successful business in Islamic banking is the existence or the backing of *Shari'ah* advice. The function of such a council or adviser

is to assure investors of the conformity and adherence of the business to the rules and requirements of the *Shari'ah*. Whether it is one adviser or a group of advisers, the selection process should be taken very seriously since it will have a great bearing on the success of the business. The selection should target prominent scholars with wide experience and solid reputations. The cost involved would be minimal since such an assignment would be part-time and of short duration. If the business is extensive or expanding, then the firm should be looking for one adviser on a permanent or retention basis. It is very important to follow the opinion of those advisers strictly and to respect their adherence to the rulings and precepts of highly regarded scholars.

Business procedures and reporting

Many Western conventional institutions think of Islamic banks as only cosmetically Islamic. They take advantage of whatever quasi-Islamic services are offered and feel that the transactions accepted by Islamic banks are only superficially different from the conventional arrangement (Delwin, 1991). Though we cannot deny the existence, in rare cases, of the use of merely definitional adjustments to rationalize interest payments, such observations may lead to an underestimation of the serious commitment of most Islamic banks to seeking complete adherence to the rules of the *Shari'ah*.

Many conventional banks make the mistake of conducting Islamic business in the same way as they conduct conventional business, with only minor cosmetic changes. Though not many changes are required in conventional procedures and reporting, careful consideration should be given to any amendments needed to reflect the spirit and structure of Islamic transactions.

Conclusions and Recommendations

Overview

This study was designed to investigate the practice of Islamic banks within different economic, financial, social and religious environments, with a view to determining both the way Islamic banks are doing their business and some of the challenges that are facing them.

The general conclusion which can be derived from the book is that while profit-and-loss-sharing is central to the theory of Islamic banking, it is quite peripheral in the actual practice of Islamic banks, and that this is so in each case studied. The unavoidable implication is that the PLS framework is not practised because it is not practicable within the current environment. It follows that Islamic economists should try to evolve, and to provide for practising Islamic bankers financial instruments which are Islamically acceptable and, at the same time, realistic and profitable. There is strong evidence to suggest that Islamic banks do not enter into PLS contracts because of the perceived high risks involved. The Qur'ān does indeed require the eradication of interest and it calls for the encouragement of legitimate commerce and trade, of legitimate wealth-creation; in neither case does the Qur'ān specify any commitment to particular contracts or types of contract, such as PLS. The banks can be regarded as Islamically successful if they succeed both in eradicating interest from their transactions and promoting commerce and trade. Islamic banks may and should concentrate exclusively on acceptable and profitable economic activity, such as trading, for instance, in commodities, property investment, property development and asset leasing. They should solicit deposits for direct investment in those activities, and trade, therefore, as quasi-investment banks. At the same time they cannot, any more than can any other financial institution, ignore the realities and costs of inflation which permeate the whole international economy. They can only solve this problem by being profitable enough to meet the need to maintain the value of their depositors' funds.

Regarding the manpower in Islamic banks the following conclusions were drawn:

- There was a lack of a consistently clear vision of the nature of the banks' business, i.e. whether they were socially responsible organizations or

whether they existed to make a profit. This confusion was evident not only on the part of clients but also on the part of bank staff.

- A lack of adequately trained staff, properly qualified to handle financial transactions and knowledgeable about the relevant areas of Islamic law.

In principle, the three criteria by which Islamic bankers assess a possible financial project are: (i) that it does not violate Islamic law; (ii) that it should maximize the bank's profit; and (iii) minimize the perceived risk.

Islamic banks are more likely to succeed as retail banks in a predominantly Muslim society. Islamic banks in non-Muslim societies face tough challenges indeed unless they adopt a niche strategy which capitalizes on the opportunities of the market and avoids the dangerous risks.

The survival and vitality of Islamic banks depend ultimately on the quality of the services offered to clients. Failure to provide the full range and right quality of services will inevitably mean that clients will switch to the Islamic counters of conventional banks. The Islamic banks should therefore learn from the techniques and experience of conventional banking whatever will assist them to improve their marketing techniques and define and deliver services to clients. This confirms what Abdul-Jabir (1987) said: 'Conventional economics is not irrelevant to either the theory or the implementation of Islamic economic policy and may in some ways be of great service'. Second, the Islamic banks must institute a formal, structured staff-training programme. Conventional banks nowadays spend what would once have been considered a large sum of money on staff training, nor is the training budget trimmed abruptly with every dip in profit. As pointed out above, Islamic banks' staff would need training in the relevant areas of Islamic law, as well as in conventional financing techniques.

The future of Islamic banks

Over the last ten years, Islamic banks have grown considerably in number and volume of business in a number of countries. In the light of the foregoing discussion, it is now appropriate to raise the following questions:

- Do Islamic banks enjoy a degree of success or not?
- Is Islamic banking a temporary phenomenon or one that is likely to survive?
- What is the way forward?

As stated previously Islamic banks have successfully negotiated two steps: (i) to determine whether it would be possible to have an alternative banking system to the conventional one. Some scholars started to lay the theoretical groundwork and background for this and to justify it to Muslims; (ii) the actual establishment of Islamic banks. The theory became real; people were willing to put their money in such institutions either as shareholders or as

depositors, and business started. Some early Islamic banks failed and shut down, but others flourished and achieved unexpected results, still others barely stayed in business without either a distinguished or a bad performance.

The future of Islamic banks hinges by and large on their ability to find a proper way of investing. They should be able to create their own investment opportunities by surveying the market both internally and externally. It is vital that they have the most highly qualified management teams, committed to the success of Islamic banking:

- Training should not be seen as a luxury, an extra, but as an essential. It can also improve the banks' marketing image with the public to be seen to be promoting the training of their employees in banking and in Islamic law.
- The future of Islamic banks depends upon them proving their usefulness, to their societies, from the point of view of socially responsible investments. There will always be a question-mark over the real difference between them and conventional banks. It is important for people to see that Islamic banks give a tangible form to their religious ideology. The challenge they face is to prove that it is possible to be both economically productive and compassionate, to seek both economic self-interest and the interest of others, and that there is no contradiction between ethics and professionalism, competence in one's field and a permanent commitment to good work in that field.
- Last, but not least, the success of Islamic banks depends heavily on their ability to find a viable alternative to interest for financing all types of loans, especially consumption loans. They should acknowledge that their success in abolishing interest has been, at the least, partial, and that they still have a long way to go in their search for a satisfactory alternative. Part of that way will surely be more quickly travelled if, as we have said, they improve their managerial capabilities by training their personnel in project-appraisal, monitoring, evaluation and performance-auditing. Their future depends also on their ability to develop, and put into practice, accounting standards that provide timely and reliable information for profit-sharing, rent-sharing or for cost-plus financing transactions. Such standards are far from adequate at present. Until they are, it is an uphill task for Islamic banks to persuade clients not already persuaded to believe that they, the banks, have a sufficient and reliable information base from which to conduct and expand their business.

It is important to remember that the Islamic banking movement has been around for only 20 years, so it is unfair to compare its results with those of the conventional banks which have been established for almost 300 years. Islamic banking is still an on-going phenomenon, still in the making. The challenge for Islamic banks is whether and how to go on surviving, then to succeed and so become an established, permanent phenomenon.

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